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In The

Supreme Court of the United States

October Term, 1995

FRANCHISE TAX BOARD
OF THE STATE OF CALIFORNIA,

Petitioner,

v.

STEPHEN B. MACFARLANE,

Respondent.

Petition For Writ Of Certiorari
To The United States Court Of Appeals
For The Ninth Circuit

PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED

When substantive tax law imposes the ultimate burden of proof upon a deduction-claiming taxpayer, is that ultimate burden of proof shifted to the taxing government when a tax claim is litigated in the bankruptcy court?

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PETITION FOR WRIT OF CERTIORARI

This petition for a writ of certiorari seeks this Court's review of the decision and opinion of the United States Court of Appeals For the Ninth Circuit, filed May 13, 1996. Unless this Court acts, this decision will result in an intercircuit conflict with respect to the important and recurring issue of whether the ultimate burden of proving entitlement to a bad debt deduction from state personal income tax is reversed when litigating claims for taxes in the bankruptcy forum.

OPINIONS BELOW

The opinion of the United States Bankruptcy Court, Southern District of California, (Appendix "C") is an unreported decision. The memorandum opinion of the United States District Court, Southern District of California, (Appendix "B") is an unreported decision. The opinion of the United States Court of Appeals For the Ninth Circuit (Appendix "A") was reported at 83 F.3d 1041 (9th Cir. 1996).

JURISDICTION

Jurisdiction of this Court to review the final order of the United States Court of Appeal for the Ninth Circuit is invoked pursuant to 28 U.S.C. § 1254(1). Pursuant to Rule 13 of the Rules of the United States Supreme Court the petition is required to be filed within 90 days after the

entry of judgment. The Ninth Circuit decided the matter and entered judgment on May 13, 1996.

CONSTITUTIONAL PROVISIONS, STATUTE AND RULES INVOLVED

(The text is provided at Appendix "D")

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STATEMENT OF CASE

William Cheng was a certified public accountant who handled all of investor Stephen B. Macfarlane's ("Macfarlane") financial, business and tax matters during 1988 and 1989. Through the execution of 19 powers of attorney, Macfarlane empowered Cheng to act with respect to all of Macfarlane's business, financial, investments, and tax matters – without monetary limitation.

Using these powers of attorney, Cheng made cash withdrawals and advances to himself from the proceeds of Macfarlane's accounts controlled by the powers of

attorney. In this manner, Cheng distributed $1,632,500 to himself in 1988 and $2,224,077 to himself in 1989 in a series of transactions in amounts as high as $500,000. While some of the distributions were purportedly for the purpose of investments in such enterprises as Cheng Information Systems, a company owned and controlled by William Cheng, Macfarlane was unaware that many of these transactions were actually used for Cheng's personal benefit. In exchange for the cash advances taken from Macfarlane's accounts, Cheng provided Macfarlane with unsecured promissory notes.

As Macfarlane's tax preparer, Cheng provided Macfarlane with blank state tax returns for tax years 1988 and 1989. Macfarlane signed the blank returns and forwarded the returns back to Cheng. Cheng then proceeded to complete the information on the returns listing as bad debt deductions the amounts which he had withdrawn from Macfarlane's accounts in 1988 and 1989, pursuant to the powers of attorney. Macfarlane had no knowledge of the contents of the tax returns at the time Cheng filed them with the state. Finding a lack of substantiation with respect to the deductions taken on Macfarlane's 1988 and 1989 state tax returns, the state disallowed the deductions and issued notices of proposed assessment.

Macfarlane filed bankruptcy in 1990 and Cheng filed bankruptcy in 1991. After filing bankruptcy, Macfarlane revoked the powers of attorney he had provided to Cheng. Macfarlane filed a protective proof of claim in his bankruptcy estate with respect to his state tax obligations. The state filed amended proofs of claim based upon the disallowance of Macfarlane's 1988 and 1989 bad debt deductions.

Macfarlane objected to the state's proofs of claim, alleging that he was entitled to a bad debt deduction; he requested a summary determination. Both sides filed pleadings supporting their respective positions. The pleadings filed by the State asserted that the debtor, Macfarlane, bore the ultimate burden of providing entitlement to the bad debt deduction which the state had disallowed based upon a lack of substantiation; the state also asserted that ultimate issues of material fact existed with respect to the controversy. After a hearing was held in the bankruptcy court, the court disallowed the state's amended proofs of claim, granting summary affirmance of the claim, and held that it was the state who bore the ultimate burden of proving that the debtor was not entitled to the deductions taken on his returns.

The state filed a notice of appeal, and the matter was ultimately heard by the district court. On June 29, 1994, the district court entered its judgment and memorandum decision affirming the bankruptcy court's denial of the state's amended proofs of claim and reversing the bankruptcy court's summary determination, holding that genuine issues of material fact existed. Macfarlane filed a motion for reconsideration on the issue of summary determination, which motion was denied.

On July 15, 1994, the state appealed to the United States Court of Appeals for the Ninth Circuit and the debtor filed a cross-appeal. The matter was argued on March 6, 1996. The opinion of the Ninth Circuit was entered on May 13, 1996. That decision affirmed the holding of the district court which denied the state's proof of claim and reversed the holding of the district court which had held that genuine issues of material fact

existed. From that decision, the state has filed this petition with the Court.

REASONS FOR GRANTING THE WRIT

I.

THE NINTH CIRCUIT'S DECISION IN THIS CASE IS IN DIRECT CONFLICT WITH THE DECISION OF THE FOURTH CIRCUIT WHICH HOLDS THAT THE ULTIMATE BURDEN OF PROVING BAD DEBT DEDUCTIONS IS NOT SHIFTED FROM THE TAXPAYER IN THE BANKRUPTCY CONTEXT

As recognized by the Ninth Circuit below, "There is no question that outside the bankruptcy forum, a taxpayer bears the ultimate burden of providing entitlement to a deduction. *United States v. General Dynamics Corp.*, 481 U.S. 239, 245 (1987)." (App. at A7.) Citing cases from the Fifth, Eighth and Tenth Circuits on one side and the Third and Fourth Circuits on the other, the Ninth Circuit also recognizes that "[c]ourts have struggled in deciding whether to import the taxpayers' ultimate burden of proof into bankruptcy proceedings." (App. at A8.) Like the Ninth Circuit, the Fourth Circuit also has directly addressed the specific issue of whether it is the debtor or the creditor which bears the ultimate burden of proof regarding entitlement to a bad debt deduction in bankruptcy claims adjudication. In a case involving claimed federal-tax bad-debt deductions,[1] the Fourth Circuit held that the ultimate burden of proving entitlement

[1] California law includes by reference the federal tax laws regarding bad debt deductions. California Revenue and Taxation Code § 17201.

to the bad debt deduction remains on the taxpayer-debtor. *In re Landbank Equity Corp. (Internal Revenue Service v. Levy)*, 973 F.2d 264 (4th Cir. 1992). The Ninth's Circuit's decision here runs directly counter to the Fourth Circuit's decision in *Landbank Equity*.

In this case the Ninth Circuit explicitly declined to follow *Landbank Equity*, holding that, "[w]hile we agree with the Board that *Landbank* is strong support for the Board's position, we do not agree with its analysis or conclusion. Nor do we consider *Landbank* controlling or persuasive because it is the only circuit decision to rule specifically on the allocation of burdens in a bankruptcy proceeding when a debtor's bad debt deduction is challenged." (App. at A9.) Thus, a direct intercircuit conflict exists with respect to this issue. This Court is urged to resolve that conflict.

II.

BY HOLDING THAT A BANKRUPTCY CONTEXT SHIFTS THE ULTIMATE BURDEN OF PROOF TO THE GOVERNMENT IN LITIGATING ENTITLEMENT TO A BAD DEBT TAX DEDUCTION, THE NINTH CIRCUIT HAS WRONGLY DECIDED A RECURRING ISSUE INVOLVING IMPORTANT POLICY CONSIDERATIONS

At issue in this case is whether a bankruptcy proceeding shifts the ultimate burden of proof regarding entitlement to income tax deductions. This is an issue

which recurs every time there is a bankruptcy court challenge to a governmental claim which is based on a disallowance of such a deduction.[2] Given the immense aggregate amount of public revenues at issue in such challenges, it is vitally important to resolve the issue of whether the burden of proof is reversed in litigating entitlement to a tax deduction in the bankruptcy court.

"[T]he assignment of the burden of proof is a rule of substantive law. . . . " *Director, OWCP v. Greenwich Collieries*, 510 U.S. ___, ___, 114 S.Ct. 2251, 2254 (1994), citing *American Dredging Co. v. Miller*, 510 U.S. ___, 114 S.Ct. 981, 988 (1994). As the Fourth Circuit correctly held in *Landbank*: "In resolving disputed claims against the bankruptcy estate, it is important to understand that the Bankruptcy Code, in most circumstances, while providing a forum and procedures for an expedient dispute resolution, does not endeavor to supplant the substantive law under which the claim against the estate . . . arose." *In re Landbank Equity Corp.*, 973 F.2d at 270 (citing Report on the Commission on the Bankruptcy Laws of the United States, H.R. Doc. No. 137, 93rd Cong. 1st Sess. Pt. I, pp. 68-71, 76-78 (1973)). The Fourth Circuit also correctly noted that "[i]t would appear that the substantive law regarding claims against the estate gives way only in those instances in which the internal goals of the bankruptcy system require alteration of externally created substantive rights," and that those exceptions are to be

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[2] In this case, the issue of entitlement arose as a result of a contested matter pursuant to Bankruptcy Rule 9014. This same issue can arise pursuant to 11 U.S.C. section 505.

(and have been) specifically provided for by Congress in the Bankruptcy Code. *Id.*

Absent a "clear and manifest" federal statutory purpose to displace traditional state regulation, the Bankruptcy Code will be construed to adopt, rather than to displace, pre-existing state law. *BFP v. Resolution Trust Corp.*, 510 U.S. ___, ___, 114 S.Ct. 1757, 1764-1765 (1994),[3] citing *English v. General Electric Co.*, 496 U.S. 72, 79 (1991). The Ninth Circuit's decision explicitly recognizes that "[t]he bankruptcy code is silent on the allocation of the ultimate burden of proof in this case.[4] (App. at A9.) Under these circumstances, the substantive tax law regarding burden of proof as to tax deductions is not preempted and is equally applicable in the bankruptcy context.

In both federal and California substantive income tax law, the ultimate burden of proving entitlement to a bad debt deduction falls clearly on the debtor. *United States v. General Dynamics Corp.*, 481 U.S. at 245; *Krumpotich v. Franchise Tax Board*, 26 Cal.App.4th 1667, 1671, 31 Cal.Rptr.2d 896, 899 (1994).[5] Under the above authorities,

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[3] Also see: Countryman, *The Use of State Laws in Bankruptcy Cases (Part I) 47 N.Y.U.L.R. 407 (1972).*

[4] Bankruptcy Rule 3001(f) simply establishes that a proof of claim constitutes evidence. The rule does not allocate burdens of proof.

[5] In this case, the Ninth Circuit held, erroneously, that the California Franchise Tax Board had the ultimate burden of proof in bankruptcy court; it also held that the Franchise Tax Board had not satisfied this purported burden. Further, the Ninth Circuit held that the taxpayer had satisfied the only burden of proof which the court assigned to the taxpayer: an intermediate

the Ninth Circuit erred in not applying this substantive tax law in the bankruptcy context.

In the absence of the required clear congressional preemption of the substantive tax law, the Ninth Circuit endorsed a preemption of California law by the bankruptcy courts' attempt to balance the equities. (App. at A 9.) This Court has recognized that the propriety of a tax deduction does not turn upon general equitable considerations; it depends upon legislative grace. *Commissioner v. National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 149 (1974).

The substantive tax law's assignment of the burden of proof to the taxpayer is not an unfair aberration. "The ordinary rule, based on considerations of fairness, does not place the burden upon a litigant of establishing facts peculiarly within the knowledge of his adversary." *United States v. New York, N.H. & H.R. Co.*, 355 U.S. 253, 256 n. 5 (1957). The basis for entitlement to a bad debt deduction relies upon facts which are peculiarly within the knowledge of the taxpayer. As a result of the possession of this knowledge, logic dictates that the taxpayer must bear the ultimate burden of proving entitlement to the claimed bad debt deduction.

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burden of only submitting sufficient evidence to rebut the prima facie validity of the Board's Claim. (App. at A8, 10.) Reversal of the Ninth Circuit's holding that the Board had the ultimate burden of proof would require a remand for consideration of whether taxpayer had satisfied the ultimate burden of providing entitlement to the bad debt deduction claimed by taxpayer.

While a debtor-taxpayer should be afforded no fewer rights in adjudicating a claim against a tax agency in a bankruptcy forum by happenstance of filing bankruptcy, the logic and rationale clearly articulated in *Landbank Equity* mandates that the debtor-taxpayer should not be afforded any greater right in adjudicating his claim by the filing of bankruptcy. *See also, Resyn Corp. v. United States*, 851 F.2d 660, 662-663 (3rd Cir. 1988).

If this decision is allowed to stand, the ruling of the Ninth Circuit will provide the debtor with an unwarranted benefit by shifting the ultimate burden of proof regarding entitlement to a tax deduction onto the governmental agency, even though the taxpayer, the party to whom the substantive tax law has allocated the ultimate burden of proof, is the party who has much superior access to the facts of the controversy. Without a granting of certiorari by this Court, a taxpayer with significant tax obligations will be encouraged to thwart those obligations by placing an insurmountable burden of proof on the taxing agency through the taxpayer's escape into the bankruptcy courts.

III.

THE NINTH CIRCUIT'S HOLDING IS NOT REQUIRED BY ANY RULES OF UNIFORMITY; THE SPIRIT UNDERLYING THE UNIFORMITY REQUIREMENT OF THE CONSTITUTION'S BANKRUPTCY CLAUSE CALLS FOR THE GRANTING OF CERTIORARI IN THIS CASE

As noted above, the Ninth Circuit's decision in this case inappropriately displaces state law which is applicable to a determination of entitlement to a bad debt deduction. In large part the Ninth Circuit relies upon "the logic" of an admittedly "broad" rule that taxing authorities are to be treated the same as other claimants. (App. at A9.) The bankruptcy clause of the United States Constitution (art. I, sec. 8, cl. 4), which empowers Congress to establish "uniform laws on the subject of bankruptcies," does not forbid Congress from distinguishing among classes of creditors; nor does it prohibit Congress from recognizing that state laws do not treat commercial transactions in a uniform manner, even though such recognition may lead to different results in different states. *Railway Labor Executives Assn. v. Gibbons*, 455 U.S. 457, 469 (1982).

The fact that the application of substantive law to the claims adjudication process in bankruptcy court may yield differing effects upon different types of creditors, or upon the same types of creditors in different states, is insufficient reason to refuse to apply state law. Under the rule stated by this Court in *Railway Labor Executives Assn.*, the equality of treatment of all creditors includes the application of appropriate substantive law in adjudicating creditors' claims.

As noted above, the conflicts between the circuits has resulted in a very real need for a uniform court rule regarding whether the burden of proof which is imposed by substantive tax law upon a deduction-claiming taxpayer is shifted to the taxing government when a tax claim is litigated in the bankruptcy court. The Ninth Circuit's decision has added to the conflict between the circuits in the general taxes-in-bankruptcy area, and it has created a direct and specific conflict with the Fourth Circuit with regard to bankruptcy tax claims arising from bad debt deductions. The spirit underlying the uniformity requirement of the United States Constitution's bankruptcy clause calls for the granting of certiorari so that this Court can establish uniformity in this area of uncertainty.

CONCLUSION

Under applicable substantive nonbankruptcy law the taxpayer bears the ultimate burden of proving entitlement to a bad debt deduction. With its decision, the Ninth Circuit has inappropriately shifted this burden to the taxing government. In the absence of express action of Congress, the courts should not take upon themselves to preempt the substantive tax law by shifting this burden of proof to the party which, by the nature of the controversy, has much less access to the determinative facts.

At this time an intercircuit conflict exists among the circuits (Fourth and Ninth Circuits) with respect to

whether the ultimate burden of proof is reversed in bankruptcy court when litigating claims involving entitlement to a bad debt deduction. This clear intercircuit conflict on an important and recurring issue needs to be clarified by this Court.

Respectfully submitted,

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APPENDIX "A"

In re Stephen MACFARLANE, Debtor.

FRANCHISE TAX BOARD OF the STATE OF CALIFORNIA,
Creditor-Appellant-Cross-Appellee,

v.

Stephen MACFARLANE, Debtor-Appellee-Cross-Appellant.

Nos. 94-56064, 94-56065.

United States Court of Appeals,
Ninth Circuit.

Argued and Submitted March 6, 1996.

Decided May 13, 1996.

California Franchise Tax Board filed claim for state income taxes, alleging that debtor's bad debt deductions were invalid. The Bankruptcy Court entered judgment for debtor, and Board appealed. The United States District Court for the Southern District of California, John Rhoades, Sr., J., reversed judgment, ruling that inferences from debtor's evidence raised triable issues of fact. Parties both appealed. The Court of Appeals, Skopil, Senior Circuit Judge, held that: (1) taxing authority has ultimate burden of proving its claim in bankruptcy proceedings, and (2) Board's reliance on alleged inconsistencies in bankrupt debtor's evidence was insufficient to meet Board's burden of proving its claim for taxes on ground that debtor's bad debt deductions were invalid.

Reversed and remanded.

Anthony Sgherzi, Deputy Attorney General, Los Angeles, California, for appellant-cross-appellee Franchise Tax Board of the State of California.

Elmer Dean Martin III, Diamond Bar, California, for appellee cross-appellant debtor Stephen B. Macfarlane.

On Appeal from the United States District Court for the Southern District of California; John S. Rhoades, District Judge, Presiding. D.C. No. CV-93-01435-JSR.

Before: SKOPIL, Senior Circuit Judge, CANBY, and LEAVY, Circuit Judges.

SKOPIL, Senior Circuit Judge:

We address in these appeals which party has the ultimate burden of proof in bankruptcy proceedings when a state files a claim for taxes alleging that a debtor's bad debt deductions are invalid. Both the bankruptcy and district courts held that the state bears the burden of proving its claim. The bankruptcy court determined that the state failed to meet its burden and entered judgment in favor of the debtor; the district court reversed, ruling that inferences drawn from the evidence create triable issues of fact. We affirm the allocation of the burden of proof; we reverse the district court's ruling and we reinstate and affirm the judgment of the bankruptcy court.

I.

Stephen B. Macfarlane (debtor) filed for bankruptcy in 1990. The Internal Revenue Service (IRS) filed a claim alleging that he owed additional taxes for 1988-89 because certain bad debt deductions were invalid. At issue were cash advances made by debtor to his financial

consultant and accountant, William Cheng, in exchange for unsecured promissory notes. The IRS contended that the advances were failed investments rather than loans. The claim was settled.

The California Franchise Tax Board (Board) thereafter filed its claim in bankruptcy court for state income taxes based on the invalidity of the same bad debt deductions. The bankruptcy court ruled that the Board's claim was prima facie valid; that debtor timely filed an objection to the claim; and that debtor provided the court with sufficient evidence to establish that the debts existed in 1988-89 and became worthless in those respective years. The court ruled that the burden shifted to the Board to prove the factual basis for its claim. The court continued the proceedings to allow the Board to conduct discovery to support its claim.

The Board elected not to conduct discovery or to submit evidence. On the basis of the evidence submitted by debtor, the bankruptcy court entered the following findings of fact:

1. The California Franchise Tax Board filed its claims in the above captioned case for income taxes, interest, additions and penalties claimed to be due from Debtor measured by his taxable income for 1988 and 1989.

2. The Debtor filed an objection to such claims, offered admissible evidence in opposition to such claims, and requested a determination of his personal liability and the liability of his estate in the above captioned case.

3. Debtor timely filed income tax returns for 1988 and 1989 with the California Franchise Tax Board claiming as deductions from income nonbusiness bad debt amounts claimed to be due to Debtor from William Cheng.

4. The deductions claimed by Debtor on these returns were $1,400,000 for 1988 and $1,378,141 for 1989.

5. Prior to December 31, 1988, Cheng had obtained at least $1,632,500 from Debtor and promised to repay this amount.

6. In 1989 Cheng obtained an additional $2,047,232 to $2,224,077 from Debtor and promised to repay this amount.

7. Cheng prepared Debtor's 1988 and 1989 California Franchise Tax Board income tax returns which claimed the deductions described in statement number 4 above for amounts due from Cheng.

8. Cheng knew when he prepared Debtor's 1988 and 1989 California Franchise Tax Board income tax returns that he could not repay the amounts he had borrowed from Debtor and accordingly prepared the returns to claim a loss for amounts due from him.

9. In April 1991 Cheng commenced a bankruptcy case under Chapter 13 of Title 11 U.S.C., and his case was converted to Chapter 7 in May 1991. Cheng admitted in his bankruptcy schedules of liabilities that he was indebted to Debtor in the amount of $2,939,722.00.

10. Cheng's bankruptcy estate has little or no value.

11. The primary asset of Cheng's estate was stock in Cheng Information Systems, Inc.

12. All of the property of Cheng Information Systems, Inc. was sold by its trustee for $2,500.

13. On December 31, 1988 and December 31, 1989, Cheng's promises to pay Debtor amounts owed to him as of such dates were worthless.

14. As of December 31, 1988 and December 31, 1989, Debtor had no realistic prospect of recovery from Cheng of any of the amounts then due to Debtor.

15. Cheng was unable to obtain a loan in 1988 or 1989 without Debtor's accommodation as a co-maker.

16. Debtor and Cheng signed documents evidencing an intent to enter into a debtor and creditor relationship and each stated orally to witnesses from time to time that a debtor-creditor relationship between them existed.

17. Cheng was in dire financial straits in 1988 and by the end of 1989 was living off loans.

18. Debtor loaned a total of $4,529,349 to Cheng.

On the basis of these findings, the bankruptcy court ruled that "Cheng was indebted to Debtor in the amounts and at the times claimed by Debtor, and such debts were worthless on December 31, 1988 and December 31, 1989

as claimed by Debtor." Judgment was entered in favor of debtor.

The Board appealed to the district court. The district court agreed with the bankruptcy court that the Board has the ultimate burden of proving its tax claim in bankruptcy proceedings. The court also agreed that whether debtor's transactions were loans and whether those loans became worthless are questions of fact. The district court reviewed the record and concluded that "[b]ased on the facts presented and the reasoning of the authorities cited . . . , the court finds the bankruptcy court's ruling was not clearly erroneous and affirms the bankruptcy court's findings of fact."

Notwithstanding that affirmance, the district court concluded that although the Board submitted no evidence and the bankruptcy court's findings were not clearly erroneous, inferences drawn from debtor's evidence raise triable issues of fact. The district court entered judgment affirming the bankruptcy court's findings of fact, but reversing the bankruptcy court's judgment.

II.

We are confronted initially by a jurisdictional concern that the district court's reversal of the bankruptcy court's judgment is not a final order because further proceedings in bankruptcy court are contemplated. Appellate jurisdiction exists only when the bankruptcy and district courts' decisions are final orders. *In re Dominguez*, 51 F.3d 1502, 1506 (9th Cir.1995). We have taken a pragmatic approach, however, to determining finality for purposes of asserting jurisdiction arising from a district court's review of a

bankruptcy decision. *See In re United Ins. Manag., Inc.*, 14 F.3d 1380, 1384 (9th Cir.1994). The district court's order will be considered final even if it remands for further proceedings in the bankruptcy court. *See id.; In re Sambo's Restaurants, Inc.*, 754 F.2d 811, 814-15 (9th Cir.1985). Thus, we have jurisdiction. Our standard of review is the same as that of the district court. *In re DAK Indus., Inc.*, 66 F.3d 1091, 1094 (9th Cir.1995). "Therefore, we review the bankruptcy court decision directly." *Id.* The bankruptcy court's findings of fact are reviewed for clear error; its conclusions of law are reviewed de novo. *Id.*

III.

There is no question that outside the bankruptcy forum, a taxpayer bears the ultimate burden of proving entitlement to a deduction. *United States v. General Dynamics Corp.*, 481 U.S. 239, 245, 107 S.Ct. 1732, 1737, 95 L.Ed.2d 226 (1987). The government's initial burden is satisfied by filing a claim that is deemed to be presumptively accurate. *McKay v. United States*, 957 F.2d 689, 691 (9th Cir.1992). The burden of proof then shifts to the taxpayer. *Oliver v. United States*, 921 F.2d 916, 919 (9th Cir.1990). The taxpayer is required to prove the merits of a claimed deduction by a preponderance of the evidence. *Rockwell v. Commissioner*, 512 F.2d 882, 885 (9th Cir.), *cert. denied*, 423 U.S. 1015, 96 S.Ct. 448, 46 L.Ed.2d 386 (1975). Similarly, under California law, a taxpayer claiming a deduction bears the ultimate burden of proving facts to justify the deduction. *Krumpotich v. Franchise Tax Bd.*, 26 Cal App.4th 1667, 1671, 31 Cal.Rptr.2d 896, 899, *review denied* (Oct. 13, 1994).

In bankruptcy proceedings, a properly filed claim constitutes prima facie evidence of the validity and amount of the claim. 11 U.S.C. §§ 501, 502(a). The debtor or trustee has the burden of presenting evidence to rebut this prima facie validity. If that burden is met, the creditor must present evidence to prove the claim. The ultimate burden of proof therefore is on the creditor. *See In re Holm*, 931 F.2d 620, 623 (9th Cir.1991); *United States v. Sampsell*, 224 F.2d 721, 722-23 (9th Cir.1955).

Courts have struggled in deciding whether to import the taxpayer's ultimate burden of proof into bankruptcy proceedings. *See, e.g., In re Wilhelm*, 173 B.R. 398, 401-02 (Bankr.E.D.Wis.1994) (deciding that IRS bears ultimate burden); *In re Premo*, 116 B.R. 515, 518-24 (Bankr.E.D.Mich.1990) (same). Unfortunately, "[t]he case law on this issue is divided with neither side making an overwhelmingly convincing argument." *Wilhelm*, 173 B.R. at 402. The Fifth, Eighth and Tenth Circuits reviewed the issue and concluded that the taxing authority bears the ultimate burden of proof in bankruptcy proceedings. *See Matter of Placid Oil Co.*, 988 F.2d 554, 557 (5th Cir.1993); *In re Gran*, 964 F.2d 822, 827-28 (8th Cir.1992); *In re Fullmer*, 962 F.2d 1463, 1466 (10th Cir.1992). The Third and Fourth Circuits reached the opposite conclusion. *Resyn Corp. v. United States*, 851 F.2d 660, 663 (3d Cir.1988); *In re Landbank Equity Corp.*, 973 F.2d 265, 268-72 (4th Cir.1992).

The Board urges us to adopt the reasoning of *Landbank* that bankruptcy courts are generally required to apply the substantive law under which the claim arose, that there is no indication that Congress implicitly intended the bankruptcy code to amend the substantive tax law regarding the taxpayer's burden of proof, and

that equity considerations do not provide a basis for shifting the taxpayer's burden of proof to the government. *Landbank*, 973 F.2d at 270-72. While we agree with the Board that *Landbank* is strong support for the Board's position, we do not agree with its analysis or conclusion. Nor do we consider *Landbank* controlling or persuasive because it is the only circuit decision to rule specifically on the allocation of burdens in a bankruptcy proceeding when a debtor's bad debt deduction is challenged. Other circuit decisions clearly establish a broad rule that taxing authorities are to be treated the same as other claimants and must therefore bear the ultimate burden of proving their claims in bankruptcy. *See, e.g., Matter of Fidelity Holding Co.*, 837 F.2d 696, 698 (5th Cir.1988) ("The Bankruptcy Code . . . does not differentiate between government and private claimants when proofs of claim are filed."). The logic of that rule is compelling to us, and accordingly, we hold that the taxing authority has the ultimate burden of proof in the bankruptcy forum.

The bankruptcy code is silent on the allocation of the ultimate burden of proof in this case. In the absence of a statutory directive, we consider it appropriate to turn to policy considerations that underlie the bankruptcy code. The district court concluded that it should balance the equities "between the Board and the other creditors of Debtor's estate." The court reasoned that since tax claims already receive a statutory priority over other creditor's claims, 11 U.S.C. § 507(a)(8)(A), relieving the Board of its burden of proof "would be granting the Board a double benefit not authorized by statute or Ninth Circuit authority." We agree. "[T]he policy goals of the bankruptcy system are put at risk when one class of creditors is given

the benefit of a favorable presumption which has its origins outside of bankruptcy law." *Wilhelm*, 173 B.R. at 402. Accordingly, we affirm the bankruptcy and district courts' rulings that the taxing authority has the ultimate burden of proving its claim in bankruptcy proceedings.

IV.

A bad debt deduction can be claimed when there is a bona fide debt and the debt became wholly worthless during the year claimed. *See* 26 U.S.C. § 166(d); Cal.Rev. & Tax.Code § 17201. The bankruptcy court reviewed the evidence submitted by debtor and found that these requirements had been fulfilled. The district court affirmed the bankruptcy court's findings. We also conclude that the bankruptcy court's findings are not clearly erroneous.

That conclusion would normally end our inquiry in favor of debtor, but here the district court reversed the bankruptcy court's judgment. The district court ruled that inferences drawn from debtor's evidence raise triable issues of fact that preclude summary judgment. There is clearly doubt, however, whether the bankruptcy court entered summary judgment. The fact that the bankruptcy court resolved factual disputes, entered findings of fact, and made conclusions of law belie the contention that summary judgment procedures were used. *See Ojai Unified Sch. Dist. v. Jackson*, 4 F.3d 1467, 1472 (9th Cir.1993), *cert. denied*, ___ U.S. ___, 115 S.Ct. 90, 130 L.Ed.2d 41 (1994). Rather, it appears that the bankruptcy court ruled

in favor of debtor because he submitted sufficient evidence to rebut the Board's claim, and the Board failed to carry its burden of proof.

Nevertheless, even if summary judgment standards are applied, we agree with debtor that the bankruptcy court's decision should be affirmed. "Once the moving party demonstrates the absence of a genuine issue of material fact, the burden shifts to the nonmoving party to produce evidence sufficient to support a jury verdict in [its] favor." *Gasaway v. Northwestern Mut. Life Ins. Co.*, 26 F.3d 957, 959 (9th Cir.1994) (quotation omitted). "This requires the nonmoving party to go beyond the pleadings and show by . . . affidavits, or by the depositions, answers to interrogatories, or admissions on file, that a genuine issue of material fact exists." *Id.* (quotations omitted).

The Board submitted no evidence of its own, but rather sought to rely on alleged inconsistencies in debtor's evidence. We agree with debtor that the Board's reliance on this evidence is insufficient to meet its burden of proving its claim; the claimed inconsistencies are insubstantial and do not create genuine issues of material fact. The judgment of the district court is REVERSED and the case REMANDED to the bankruptcy court for entry of judgment in favor of Macfarlane.

REVERSED and **REMANDED.**

APPENDIX "B"

UNITED STATES DISTRICT COURT

Southern District of California

IN RE: STEPHEN B. MACFARLANE, Debtor

CALIFORNIA FRANCHISE TAX, Appellant

V.

STEPHEN B. MACFARLANE, Appellee

JUDGMENT IN A CIVIL CASE

(Filed Jun. 29, 1994)

CASE NUMBER: 93-1435 G/R

[ ] Jury Verdict. This action came before the Court for a trial by jury. The issues have been tried and the jury has rendered its verdict.

[X] Decision by Court. This action came to trial or hearing before the Court. The issues have been tried or heard and a decision has been rendered.

IT IS ORDERED AND ADJUDGED

the Bankruptcy Court's findings of fact and conclusions of law on the motion for denial of claim, Bankruptcy Docket #181, are affirmed and the Bankruptcy Court's grant of summary judgment denying the Board's claim, Bankruptcy Docket #235 is reversed .....

June 29, 1994
Date

Roberta Westdal
Clerk

M. Stottlemyer /s/ M. Stottlemyer
(By) Deputy Clerk

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF CALIFORNIA

IN RE: STEPHEN B. MACFARLANE, Debtor. CALIFORNIA FRANCHISE TAX Appellant, v. STEPHEN B. MACFARLANE, Appellee.	Civil No. 93-1435 G/R MEMORANDUM DECISION AFFIRMING IN PART AND REVERSING IN PART BANKRUPTCY COURT'S DECISION[1] (Filed Jun. 29, 1994)

ISSUES ON APPEAL:

1. Whether the bankruptcy court erred when it held that the California Franchise Tax Board, ("Board") has the ultimate burden of proof with respect to the issue of whether or not Stephen MacFarlane, ("Debtor") is entitled to a "bad debt deduction" for income tax purposes?

2. Whether the bankruptcy court was clearly erroneous when it found that the Debtor made loans in 1988 and 1989 and the loans were totally worthless by the end of 1988 and 1989?

3. Whether the bankruptcy court erred when it held that Debtor was entitled to a bad debt deduction as a

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[1] Pursuant to Southern District of California Rule 7.1(d)(1) and Fed. R. Bankr. P. 8012(3) this court finds this appeal suitable for decision without oral argument.

matter of law, and granted summary judgment in favor of the Debtor disallowing the claim filed by the Board?

FACTS

During the years in question, William Cheng ("Cheng") handled the financial affairs of the Debtor as a consultant and accountant. The Debtor gave Cheng a general power of attorney in 1983 and numerous special powers of attorney. Cheng had the authority to act with respect to any of the Debtor's commercial, checking, savings or money market accounts. Cheng had the power to withdraw funds, sign all checks for bills and investments, and to buy, sell or borrow against the Debtors securities. Cheng maintained this authority during 1988 and 1989.

In 1988, the Debtor provided Cheng with approximately $1,632,500 in cash advances via unsecured promissory notes. In 1989, the Debtor provided Cheng with an additional $2,224,077 in cash advances via unsecured promissory notes.

Cheng prepared and signed the Debtor's tax returns in 1988 and 1989. The Debtor claimed bad debt deductions of $1,400,000 on his 1988 tax return and $1,378,141 on his 1989 return. The bad debt deductions claimed by Debtor resulted from the cash advanced to Cheng that he was unable to repay.

The Debtor filed bankruptcy in 1990. Cheng filed bankruptcy in 1991. In June of 1991, the Internal Revenue Service (IRS) issued an audit report which determined that the deduction for the bad debts at issue in this case should be disallowed. The Debtor contested the IRS claim

in bankruptcy court. In April of 1992, the Board issued a notice of proposed assessment disallowing the bad debt deductions on the Debtor's state return for 1988 and 1989. In October of 1992, the IRS and the Debtor settled the matter. The parties agreed that only $250,000 of the original $1,339,750 claim was owed by the Debtor and the Debtor withdrew another unrelated claim for refund. The Boards' notice of proposed assessment was not affected by the Debtor's settlement with the IRS.

PROCEDURAL HISTORY

The Board filed a proof of claim in the Debtor's estate, in August of 1993, for state income taxes. The Board's proof of claim resulted from a disallowance of a bad debt deduction taken on the Debtor's 1988 and 1989 state income tax returns. The Debtor filed an objection to the Board's proof of claim and the bankruptcy court scheduled a hearing for March 15, 1993.

At the March 15, 1993 hearing, the bankruptcy court held: the Board's proof of claim was prima facie valid; the Debtor timely filed an objection to the claim; the Debtor provided the court with sufficient evidence to establish that a debt existed between the parties in 1988 and 1989, and that the debt was worthless in 1988 and 1989. R.A. 169. In addition, the court held that the Board had the burden of persuasion to prove the factual basis for its claim. *Id.* at 170.

The bankruptcy court also granted the Board time to conduct discovery to support its claim and continued the matter to July 12, 1993. *Id.* at 170-72. The Board did not conduct any discovery during this period. *Id.* at 78-79. In

June of 1993, the Debtor filed a motion for summary determination denying the Board's claim. This motion was pursuant to Fed. R. Civ. P. 56 made applicable by Fed. R. Bankr. P. 7056. The bankruptcy court entered its judgment denying the Board's claim and its findings of fact and conclusions of law on August 10, 1993.

The Board filed its notice of appeal on August 19, 1993. On September 1, 1993, the Debtor objected to the reference of the appeal to the Bankruptcy Appellate Panel of the Ninth Circuit. The parties submitted the final briefs on January 5, 1994. This matter was referred to the Honorable Marilyn L. Huff during the absence of the Honorable Earl B. Gilliam. This appeal was calendared to be decided on May 9, 1994. On May 20, 1994 Judge Huff recused herself from the case because of a possible conflict. This appeal was reassigned to this court on May 20, 1994.

THE BANKRUPTCY COURT'S DECISION

At the July 12, 1993 hearing, Judge Bowie disallowed the Board's proof of claim; holding that the Debtor had no income tax liability to the Board for the period in question. The bankruptcy court made the following findings of facts relevant to this appeal: (1) Cheng had obtained $1,632,500 from Debtor prior to December 31, 1988 and promised to repay that amount; (2) in 1989, Cheng obtained an additional $2,047,032 to $2,224,077 and promised to repay that amount; (3) on December 31 1988, and December 31 1989, Cheng's promises to pay the Debtor the amounts owed were worthless; (4) Cheng knew the debts were worthless when he prepared the

Debtor's 1988 and 1989 state franchise tax returns, and accordingly claimed a loss for the amounts due from him; (5) Debtor and Cheng signed documents evidencing an intent to create a debtor-creditor relationship and each stated to witnesses that a debtor-creditor relationship existed.

In addition, at the July 12, 1993 hearing the bankruptcy court made the following conclusions of law relevant to this appeal: (1) the Board's proof of claim is presumptively entitled to prima facie validity, until Debtor presents admissible evidence which tends to rebut the presumption; (2) the Debtor met his burden of rebutting the presumption in this case; (3) the Board has the ultimate burden of proof on the validity of the claim at issue; (4) a debt is an obligation to pay money; (5) Cheng agreed to pay Debtor the amounts claimed by Debtor on his 1988 and 1989 returns; (6) a debt is deductible when it becomes worthless; (7) a debt is worthless when there is no reasonable possibility of repayment and there are reasonable grounds for abandoning any hope of payment in the future; (8) Cheng's debts to Debtor were worthless on December 31, 1988 and December 31, 1989; (9) the Board has not introduced any evidence in this matter; (10) the deposition testimony of Leslie Szutenbach and John Haegen establish the existence and amounts of loans claimed by Debtor; (11) the testimony of Leslie Szutenbach and Karen Joyce and the documents offered by Debtor, including the admissions of Cheng, establish that Cheng was insolvent as of December 31, 1988 and December 31, 1989 and (12) the evidence offered by Debtor is not controverted by the Board.

DISCUSSION

A. Standard of Review

The district court acts as an appellate court when reviewing appeals from the bankruptcy court. 28 U.S.C. §158(a). The court must review the bankruptcy courts findings of fact under the clearly erroneous standard, and conclusions of law de novo. Fed. R. Bankr. P. 8013. Under the clearly erroneous standard, this court will not disturb the bankruptcy court's findings of fact if "the evidence is plausible in light of the record viewed in its entirety." *Anderson v. City of Bessemer City*, 470 U.S. 564, 574 (1985). This court must review a grant of summary judgment by the bankruptcy court de novo. *Crane v. The Arizona Republic*, 972 F.2d 1511, 1516 (9th Cir. 1992).

The procedural history in this case indicates that the bankruptcy court had both a motion for denial of claim and a motion for summary judgment on denial of the claim before it at the July 12, 1993, hearing. The docket of the bankruptcy court indicates that the Debtor had filed an Objection To The Board's Proof of Claim, on January 11, 1993 (#181) and a Motion For Summary Determination Denying The Board's Claim on June 11, 1993 (#236). Accordingly, this court must consider this matter as both an appeal from a summary judgment and an appeal from the bankruptcy court's decision on the merits of the Board's Proof of Claim.

B. Burden Of Persuasion.

There is a conflict between the circuits with respect to the ultimate burden of persuasion regarding tax claims in

contested matters in bankruptcy court; particularly those with respect to entitlement to bad debt deductions.

Under the tax code, the burden of persuasion is on the taxpayer to prove entitlement to a claimed deduction. Deductions are a matter of legislative grace, and the taxpayer must show that every condition imposed by Congress is satisfied. *Levy v. Conlon*, 973 F.2d 265, 269 (5th Cir. 1992); *Keogh v. C.I.R.*, 713 F.2d 496, 501 (9th Cir. 1983).

On the other hand, in bankruptcy court, a proof of claim establishes a prima facie case against the debtor's assets. The objecting party must then produce evidence rebutting the claimant, or the claimant will prevail. If, however, evidence rebutting the claim is brought forth, then the claimant must produce additional evidence to prove the validity of the claim by a preponderance of the evidence. The ultimate burden of persuasion rests upon the claimant. *California State Board Of Equalization v. Official Unsecured Creditors' Committee*, 837 F.2d 696, 698 (5th Cir. 1988).

The issue before the court is whether in the context of a bankruptcy proceeding, the burden of showing entitlement to a deduction for bad debts shifts from the taxpayer to the Board. The court in *Levy* discussed the conflict in the circuits on this issue. The *Levy* court found that the majority of circuits which have addressed the issue have decided that a dispute between a taxpayer and a taxing agency should not be decided in a bankruptcy context any different than it would be outside of a bankruptcy forum. Following this line of precedent, the Debtor would retain the burden of proving its bad debt deduction was proper. *See Resyn Corp. v. United States*, 851

F.2d 660, 662-63 (3rd Cir. 1988); *United States v. Uneco Inc.*, 532 F.2d 1204, 1207 (8th Cir. 1976). There is an alternative line of authority which holds that the Bankruptcy Code does not differentiate between government and private claimants when proofs of claim are filed. Under this authority, the Board would have the ultimate burden of persuasion concerning the validity of the bad deduction. *See California State Board Of Equalization*, 837 F.2d at 698; *Cebollio v. C.I.R.*, 967 F.2d 986, 989-990 (4th Cir. 1992) (taxpayer has burden to show the taxing agency's deficiency notice is in error, burden shifts to agency to determine correct amount of deficiency.).

This is an issue of first impression in the Ninth Circuit. However in *In re Imperial Corporation of America*, a bankruptcy court in the Southern District of California held that the party making a claim against the estate of the debtor has the burden of establishing all requisite elements of its claim, even if the claimant is the IRS. *In re Imperial Corporation of America*, 1991 WL 281712 (Bankr. S.D. Cal.).

This court is not bound to follow either line of authority. A review of the language of the Bankruptcy Code offers little guidance on this issue. Courts have interpreted this omission in different ways. For example, the court in *California State Board of Equalization v. The Official Unsecured Creditor's Committee*, the court held that burden of persuasion is on the taxing agency to prove the validity of their claim because Bankruptcy Rule 3001 does not differentiate between the government and private claimants when a proof of claim is filed. *California State Board of Equalization*, 837 F.2d at 698. On the other hand, the court in *Internal Revenue Service v. Levy*, held that

taxpayers have the burden of proving they are entitled to deductions even in a bankruptcy forum. The *Levy* court stated, "Thus upon review of the [Bankruptcy] code and its legislative history, we find nothing which suggests that this dispute between a taxpayer and the IRS should be decided in a manner any different from that in which the case would be determined outside the bankruptcy context." *Levy*, 973 F.2d at 271. Thus the court finds that the language of the statute does not provide a clear path to resolve this issue.

The court, after finding there is no binding statutory language or case authority which resolves this issue, finds there is an equitable argument which supports assigning the Board the burden of persuasion in this case. Bankruptcy courts sit as courts of equity. *In re Shoreline Concrete Co., Inc.*, 831 F.2d 903, 905 (9th Cir. 1987). (citations omitted). The Supreme Court has stated: the "touchstone of each decision on allowance of interest in bankruptcy . . . has been a balance of equities between creditor and creditor or between creditor and the debtor." *United States v. Ron Pair Enterprises, Inc.*, 489 U.S. 235, 248 (1989). This language in *Ron Pair Enterprises, Inc.*, suggests that this court should take into account the balance of equities between the Board and the other creditors of Debtor's estate.

Under applicable statutory law, tax claims may be afforded priority over other creditors' claims under 11 U.S.C. §507(a)(7)(A)(i), (ii), (iii) if the tax was due prepetition, or if the tax could have been assessed prior to the debtor's petition. If this court relieves the Board of its burden of persuasion, it would be granting the Board a double benefit not authorized by statute or Ninth Circuit

authority. The Board's tax claim may be afforded priority over the claims of other creditors, without the Board having the same obligation of other creditors to prove by a preponderance of the evidence, the validity of their claim.

In their papers, the Board argues that this court should not apply the equitable objective of equality in distribution at the claims allowance stage of the process. Instead, the Board argues, the court should only consider equality of treatment for allowed claims and should apply the clear mandate of bankruptcy courts to apply non-bankruptcy law to the claims adjudication process.

The court rejects this argument because it is not well supported. The Board has provided an abundance of case law to show that bankruptcy courts have applied non-bankruptcy substantive law to other issues in the claims adjudication process. (Appellant's Opening Brief pp. 12-14). However, the Circuits are split with respect to whether federal tax law should be applied in this instance. This is a far cry from a clear mandate that this court must apply tax law to the burden of proof issue in this appeal.

Additionally, the Board has cited no authority suggesting that bankruptcy courts, which sit as courts of equity, should not apply equitable principles during the claims allowance phase of the bankruptcy proceeding. In the Ninth Circuit, bankruptcy courts must follow the law in the same manner as other courts of equity. *In re Shoreline Concrete Co., Inc.*, 831 F.2d at 905. However, the Board's argument that this court cannot apply equitable

principles at the claims allowance stage begs the question. The Board must first establish that there is statutory or case authority which dictates applying tax law to the burden of persuasion issue, before the court can find that the bankruptcy court did not follow the law. The Board failed to provide sufficient authority that this court must apply tax law to the burden of persuasion issue in this appeal, and therefore, the court rejects the Board's argument.

Based on the facts presented and the reasoning of the authorities cited above, the court holds that the Board has the ultimate burden of persuasion to prove the validity of its claim.

C. Standards For Bad Debt Deduction

This court must look at the financial condition of the debtor and the circumstances relating to the debt to determine if a bad debt deduction is appropriate. In order for a taxpayer to take a bad debt deduction, the applicable statute requires: (1) the existence of a debt; (2) the debt had value at some time during the taxable year; (3) the debt became worthless during the taxable year; (4) and there was a reasonable expectation of repayment. 26 U.S.C. §166.

A valid debt is an enforceable obligation to pay a fixed or determinable sum of money. *Piggy Bank Stations, Inc. v. C.I.R.*, 755 F.2d 450, 453 (5th Cir. 1985). The question of whether the payments or distributions of a taxpayer are debts for tax purposes is a question of fact. *Id.* at 454; *Los Angeles Shipbuilding & Drydock Corp. v. United States*, 289 F.2d 222 (9th Cir. 1961). In the *Piggy Bank*

Stations decision, the court considered the following factors to determine if a cash distribution was a valid debt: (1) the names given to the instruments evidencing the indebtedness; (2) the presence or absence of a fixed maturity date and repayment schedule; (3) whether any security was given; (4) the intent of the parties; (5) the ability of the receiving party to obtain loans from third-party lenders; (6) the failure of the debtor to repay on the due date or seek a postponement. In *Stinnett's Pontiac Service Inc. v. C.I.R.*, 730 F.2d 634, 638 (11th Cir. 1984) the court indicated how the multi-factor test should be applied: "the approach of this court has been to consider all the factors and weigh the evidence favoring characterization of the advance as debt or equity, while realizing that the various factors are not of equal significance and that no one factor is controlling." *Id. quoting, Estate of Mixon v. United States*, 464 F.2d 394, 402 (5th Cir. 1972).

If the distribution of cash by the Debtor is considered a debt, than the court must determine if the loan had any potential or current intrinsic value in the beginning of the year in which it allegedly becomes worthless and that it actually becomes worthless during the year in question. *Estate of Mann*, 731 F.2d 267, 275 (5th Cir. 1984). Worthlessness in a particular year is a question of fact. *Id.* The *Estate of Mann* court held that:

> A taxpayer must prove that on January 1 of the taxable year the debts had some intrinsic or potential value, and that by December 31 the debts had lost all such value . . . Debts are wholly worthless when there are reasonable grounds for abandoning any hope of repayment in the future. . . . This will usually entail proof of

> the existence of identifiable events which demonstrate the valuelessness of the debts . . . If and when such debt becomes wholly worthless must be determined from the facts and circumstances known or which could have reasonably been known at the end of the year of asserted worthlessness.

Id. at 275-76.

D. Review of the Bankruptcy Court's Findings of Fact

The record before the court establishes that the bankruptcy court's holding that the Debtor established that his cash distributions to Cheng were loans and that the loans were worthless in 1988 and 1989 should be affirmed under the clearly erroneous standard for findings of fact. Whether distributions by a taxpayer are debts is a question of fact. *Piggy Bank Stations Inc.*, 755 F.2d at 454; *Los Angeles Shipbuilding & Drydock Corp.*, 289 F.2d at 222. Similarly, the question of when a debt becomes worthless is also a question of fact. *Estate of Mann*, 731 F.2d 267, 275 (5th Cir. 1984). Proof of the validity of a claim must be made by a preponderance of the evidence. *California State Bd. of Equalization v. Official Unsecured Creditor's Committee*, 837 F.2d 696, 698 (5th Cir. 1988).

At the July 12, 1993 hearing, the bankruptcy court stated that it relied on a January 1987 letter from the Debtor to Cheng when the court found that the funds Debtor advanced to Cheng were loans. R.A. 75. In that letter, Cheng expressly indicated that the parties were entering into a secured lender relationship and not an investment relationship. R.A. 547-48.

The court also indicated that it considered other evidence that the Debtor and Cheng established a lender relationship. R.A. 76. This evidence includes multiple copies of checks which indicate "loan" on the memo line, a February 26, 1987 note which indicates a $500,000 loan, a May 6, 1987 loan which increased the prior loan by $250,000, a May 25, 1987 unsecured promissory note for $250,000, a February 18, 1987 unsecured promissory note for $250,000, and an undated promissory note for $1,000,000. R.A. 547-559.

The bankruptcy court also considered the following evidence: a July 31, 1988 loan agreement between Debtor and Cheng which acknowledged a loan of $1,250,000 and a June 28, 1988 letter from Cheng's legal counsel which characterized the transactions between Cheng and Debtor as loans; R.A. 1004-10013, a July 19, 1988 promissory note for $600,000 R.A. 1001; and a promissory note dated September 25, 1987, which contains an interest rate and a repayment schedule. R.A. 1003.

In addition, the bankruptcy court rejected the Board's argument that the Debtor could not have had a reasonable expectation of repayment of funds advanced in 1989, after the Debtor signed his 1988 tax return which indicated a bad debt deduction for Cheng in 1988. The bankruptcy court found that the 1988 tax returns were not signed until October of 1989, and the fact that Cheng was unable to pay back his 1988 obligations does not establish that he was unable to pay obligations made on loans in 1989. R.A. 74.

The bankruptcy court also rejected the Board's contention that the all-inclusive power of attorney the Debtor

gave Cheng is inconsistent with an intent to make a loan to Cheng. The bankruptcy court held that the Debtor's evidence established that he intended to have a debtor/creditor relationship with Cheng and the Board had the burden to show a particular transaction during 1988 and 1989 was not a valid loan. R.A. 78, 81.

The bankruptcy court further found that the Board had the burden to prove that the Debtor advanced some of the funds to Cheng to generate a loss for a tax shelter. R.A. 77. The bankruptcy court rejected the Board's argument that the Debtor's deposition testimony indicating that he needed a tax shelter, establishes the Debtor did not advance funds to Cheng with a reasonable expectation of repayment. The bankruptcy court found that the Board failed to provide any evidence indicating that Cheng used the Debtor's funds in a manner which established it was not a loan.

The Board also argued that the cash advances from Debtor to Cheng evidenced by unsecured promissory notes should not be considered loans, because cash advances for large sums of money usually require security. The Board cites *Matter of Uneco, Inc.*, 532 F.2d 1204 (8th Cir. 1976) for the proposition that the absence of an assignment of security has been viewed by many courts as a key factor against finding bona fide indebtedness. However the Board failed to indicate that the *Uneco* court also held that when determining the validity of a bad debt deduction, there is no one controlling factor or broad rule that can be used in deciding these cases. *Id.* at 1208. The *Uneco* court held that each case turns upon its particular facts and the varying indicia applied in determining the issue may or may not have relevancy to a

particular case. *Id.* at 1207. Based on the reasoning of the *Uneco* case cited by the Board, the court rejects the Board's argument that the absence of security in certain promissory notes indicates that the transactions were not loans.

The record before the bankruptcy court also indicates that the Debtor provided evidence that the loans were worthless in 1988 and in 1989. The bankruptcy court considered the deposition testimony of Leslie Szutenbach, Cheng's former accountant. R.A. 72. Ms. Szutenbach testified that Cheng informed her he was unable to pay back the debtor and instructed her to write off the loans as bad debt the [sic] Debtor's tax return. R.A. 743, 744. The bankruptcy court also considered the declaration of Karen Joyce, Cheng's former bookkeeper. R.A. 73. Joyce's declaration indicated that Cheng did not have the ability to pay back the loans to the Debtor in 1988 and 1989. R.A. 560-564.

The Board argues that the Debtor's failure to indicate an identifying event showing that the debts to Cheng were worthless in 1988 and 1989 precludes the court form finding that the debt became worthless in the taxable year of the deduction. The case law indicates that proof of an identifiable event is generally required to show proof of worthlessness. *Estate of Mann*, 731 F.2d 267, 275 (5th Cir. 1984). However, the Board has provided no authority which indicates that an identifiable event is an essential element of proof of worthlessness, or that the bankruptcy court is required to find an identifiable event which signals that the loans are worthless. The bankruptcy court is not required to find an identifiable event which signals that the loans are worthless. The Supreme Court had held

that "if the district court's account of the evidence is plausible in light of the record viewed in its entirety, the court of appeals may not reverse even though convinced that had it been sitting as the trier of fact, it would have weighed the evidence differently. *Anderson v. City of Bessemer City*, 470 U.S. 564, 574 (1985). In this case, the bankruptcy court's factual finding is plausible. The bankruptcy court relied on the testimony of percipient witnesses who testified that Cheng did not have the ability to repay the Debtor. In *Cole v. C.I.R.*, the court held that facts which might support a claim of worthlessness include the lack of assets of the creditor. *Cole v. C.I.R.* 871 F.2d 64, 67 (7th Cir. 1989). It is not implausible for the bankruptcy court to consider the uncontested evidence of Cheng's accountant and bookkeeper as sufficient evidence that Cheng did not have the ability to repay the Debtor.

The court finds that there is sufficient evidence to support the bankruptcy court's finding that the transactions between the Debtor and Cheng were loans and that the loans were worthless in 1988 and 1989.

The bankruptcy court's finding that the transactions were loans and the debts were worthless in 1988 and 1989 was not clearly erroneous. The bankruptcy court took into account the following factors: the instruments evidencing the transaction indicated they were loans; some of the promissory notes indicated a repayment date and interest, the parties indicated in correspondence that the transactions were considered loans and not investments, in a letter to debtor Cheng pledged security for the loans, and the declaration and affidavit testimony of Cheng's

former accountant and bookkeeper that Cheng was unable to repay the Debtor in 1988 and 1989.

In their papers, the Board incorrectly assumed that this court would only be reviewing the case under the de novo standard. As a result, the Board did not address the bankruptcy court's ruling under the clearly erroneous standard.

Based on the facts presented and the reasoning of the authorities cited above, the court finds the bankruptcy court's ruling was not clearly erroneous and affirms the bankruptcy court's findings of fact.

E. Review of The Bankruptcy Court's Grant of Summary Judgment

The court must also determine under the de novo standard whether the bankruptcy court properly granted summary judgment on the issue of whether the Debtor loaned money to Cheng.

Fed. R. Civ. P. 56(c) provides that summary judgment is appropriate if the "pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to judgment as a matter of law." One of the principal purposes of the rule is to dispose of factually unsupported claims or defenses. *Celotex Corp. v. Catrett*, 477 U.S. 317, 325 (1986).

Once the moving party meets the requirement of Rule 56 by either showing that no genuine issue of material fact remains or that there is an absence of evidence to

support the non-moving party's case, the burden shifts to the party resisting the motion, who "must set forth specific facts showing that there is a genuine issue for trial." *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 256 (1986). It is not enough for the party opposing a properly supported motion for summary judgment to "rest on mere allegations or denials of his pleadings." *Id.* Genuine factual issues must exist that "can be resolved only by a finder of fact because they may reasonably be resolved in favor of either party." *Id.* at 250.

To make such a showing, the non-moving party must go beyond the pleadings to designate specific facts showing that there is a genuine issue for trial. *Celotex*, 477 U.S. at 325. The court must draw all inferences in favor of the party opposing summary judgment. Summary judgment will only be granted if all reasonable inferences defeat the opposing party's claim. *Admiralty Funds v. Tabor*, 677 F.2d 1297, 1298, 1299 (9th Cir. 1982).

The record before the court indicates that in addition to the checks, promissory notes and loan agreements mentioned by the bankruptcy court during the July 12, 1993 hearing, there is also deposition testimony by the Debtor that he loaned money to Cheng. See R.A. 338,354,356,364.

In their papers, the Board argues that the evidence offered by the Debtor is controverted and creates a genuine issue of triable fact concerning whether the funds Debtor advanced Cheng were debts for tax purposes. The Board offered the following detrimental aspects of the Debtor's evidence to show that no valid debt existed between the Debtor and Cheng.

The Debtor testified in his deposition that Cheng did not have permission to use the Debtor's money for the purposes it was used. R.A. 338. The Board argues this creates an issue of whether the Debtor expected repayment of funds that he advanced without knowing how Cheng used the money.

The Debtor also testified in his deposition that he discussed with Cheng about investing in tax shelters to lessen his tax burden. R.A. 255. The Board argues that this statement creates an issue of whether the Debtor advanced funds to Cheng with an expectation of repayment or to generate a tax loss. The Board concedes that the extent to which these cash advances from the Debtor to Cheng represent tax shelter activity is unknown. Although the Board has the ultimate burden of proof to establish to what extent the funds advanced to Cheng were for the purpose of a tax shelter, the Board has pointed to sufficient evidence in the record to create a triable issue that some of the funds were not loans and were used to generate a tax loss.

The Debtor testified that he was unable to distinguish cash advances to Cheng as a loan, from cash advances given to Cheng for investing. R.A. 356-57. The Debtor also testified that at least $1,000,000 of the cash advance to Cheng was an investment in an entity called Cheng Information Systems. R.A. 359. The Board argues that this testimony creates an issue as to whether the funds advanced to Cheng were loans or investments.

The Board also points to documents in the record which raise inferences that the Debtor did not have a valid bad debt deduction in 1988 and 1989. The Board

pointed out two promissory notes dated February 26, 1987 and May 6, 1987, in which the Debtor is offering to lend Cheng $500,000 and $750,000 that do not contain a repayment date, do not bear an interest rate, and do not contain any security. R.A. 549-550. The Board argues that the court could infer that these documents do not evidence a valid debt. These unsecured promissory notes satisfy few of the factors courts analyze to determine whether a debt is valid for tax purposes.

Although the instruments are entitled promissory notes, they do not contain a fixed maturity date and repayment schedule, they do not contain any security, and would not be commercially acceptable to third-party lenders. The court finds that the Board has pointed to sufficient evidence in the record to defeat summary judgment on the issue of whether the promissory notes evidence valid debts.

As noted earlier, the court declines to disturb, under the clearly erroneous standard, the bankruptcy court's finding of fact on the merits. The bankruptcy court found that the debtor established a lender/creditor relationship with Cheng, and the Board failed to meet its burden of showing these particular transactions were not valid loans. The court's rulings are not inconsistent. The bankruptcy court's findings of facts on the merits are reviewed under the clearly erroneous standard, while the motion for summary judgment is reviewed de novo.

To survive summary judgment under *Celotex*, the Board must set forth specific facts showing there is a genuine issue for trial. The Board cited numerous excerpts from the record, which create a genuine issue of

triable fact whether the funds the Debtor advanced to Cheng were loans. In summary, The Board cited the following evidence: Debtor testified that Cheng did not have permission to use his money for the purposes in which it was used (R.A. 338); Debtor testified that he needed a taxable loss to lessen his tax bill (R.A. 255); the alleged loans are totally unsecured, despite the language of a January 12, 1987 letter that the loans would be secured by pledges of stock (R.A. 549-50); and promissory notes dated February 26, 1987 and May 6, 1987, that do not contain a date the alleged loan is due, an interest rate, or security (R.A. 549-50). Viewing all inferences that can be drawn from the excerpts of the record cited by the Board in a light most favorable to the Board, the court finds that all reasonable inferences do not defeat the Board's claims.

Accordingly, based on the reasoning of the *Celotex* and the *Admiralty Funds* decisions and the facts presented, the court reverses the bankruptcy court's grant of summary judgment.

CONCLUSION

The bankruptcy court's findings of fact and conclusions of law on the motion for denial of claim, bankruptcy docket #181, are affirmed and the bankruptcy court's grant of summary judgment denying the Board's claim, bankruptcy docket #236 is reversed.

IT IS SO ORDERED.

Date: 6/10/95

/s/ John S. Rhoades
JOHN S. RHOADES
UNITED STATES
DISTRICT JUDGE

APPENDIX "C"

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Special Counsel for Debtor Stephen B. Macfarlane

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF CALIFORNIA

In re	)	Case No. SD 90-11375 B11
STEPHEN B. MACFARLANE,	)	Chapter 11
Debtor.	)	JUDGMENT DENYING FRANCHISE TAX BOARD CLAIM
	)	DATE: July 12, 1993
	)	TIME: 2:00 o'clock p.m.
	)	PLACE: 940 Front Street Department 4 San Diego, Cal.

(Filed Aug. 10, 1993)

The motion of the Debtor for a denial of the claims of the California Franchise Tax Board on file in this case and for determination of Debtor's personal liability for the taxes represented by such claims in the contested matter commenced by Debtor's objection to such claims came on for hearing on July 12, 1993 before the Honorable Peter W. Bowie, United States Bankruptcy Judge in Department

4 of the United States Bankruptcy Court for the Southern District of California.

The Court having considered the evidence offered by the Debtor and the arguments of the parties and having made its Findings of Facts and Conclusions of Law on file herein,

IT IS HEREBY ADJUDGED, ORDERED AND DECREED:

1) The claims of the California Franchise Tax Board in this case for income taxes measured by Debtor's taxable income for 1988 and 1989 are denied and the California Franchise Tax Board shall receive no payment from Debtor's estate in this case;

2) The personal liability of the Debtor to the California Franchise Tax Board for interest, additions or penalties measured by Debtor's taxable income for 1988 and 1989 is determined to be zero and the California Franchise Tax Board shall receive no payment from Debtor for the taxes, interest, additions or penalties claimed by the California Franchise Tax Board in its claims in this case.

Dated: AUG 10 1993, 1993.

/s/ Peter W. Bowie
United States Bankruptcy Judge

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Special Counsel for Debtor Stephen B. Macfarlane

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF CALIFORNIA

In re	Case No. SD 90-11375 B11
STEPHEN B. MACFARLANE,	Chapter 11
Debtor.	FINDINGS OF FACT AND CONCLUSIONS OF LAW REGARDING FRANCHISE TAX BOARD CLAIMS
	DATE: July 12, 1993
	TIME: 2:00 o'clock p.m.
	PLACE: 940 Front Street, Department 4, San Diego, Cal.

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W. Bowie, United States Bankruptcy Judge in Department 4 of the United States Bankruptcy Court for the Southern District of California. Debtor appeared by Elmer Dean Martin III and the California Franchise Tax Board appeared by Anthony Sgherzi, Deputy Attorney General of the State of California.

The Court having considered the record and pleadings in this contested matter and the oral arguments, the Court hereby finds:

1. The California Franchise Tax Board filed its claims in the above captioned case for income taxes, interest, additions and penalties claimed to be due from Debtor measured by his taxable income for 1988 and 1989.

2. The Debtor filed an objection to such claims, offered admissible evidence in opposition to such claims, and requested a determination of his personal liability and the liability of his estate in the above captioned case.

3. Debtor timely filed income tax returns for 1988 and 1989 with the California Franchise Tax Board claiming as deductions from income nonbusiness bad debt amounts claimed to be due to Debtor from William Cheng.

4. The deductions claimed by Debtor on these returns were $1,400,000 for 1988 and $1,378,141 for 1989.

5. Prior to December 31, 1988, Cheng had obtained at least $1,632,500 from Debtor and promised to repay this amount.

6. In 1989 Cheng obtained an additional $2,047,232, to $2,224,077 from Debtor and promised to repay this amount.

7. Cheng prepared Debtor's 1988 and 1989 California Franchise Tax Board income tax returns which claimed the deductions described in statement number 4 above for amounts due from Cheng.

8. Cheng knew when he prepared Debtor's 1988 and 1989 California Franchise Tax Board income tax returns that he could not repay the amounts he had borrowed from Debtor and accordingly prepared the returns to claim a loss for amounts due from him.

9. In April 1991 Cheng commenced a bankruptcy case under Chapter 15 of Title 11 U.S.C., and his case was converted to Chapter 7 in May 1991. Cheng admitted in his bankruptcy schedules of liabilities that he was indebted to Debtor in the amount of $2,939,722.00

10. Cheng's bankruptcy estate has little or no value.

11. The primary asset of Cheng's estate was stock in Cheng Information Systems, Inc.

12. All of the property of Cheng Information Systems, Inc. was sold by its trustee for $2,500.

13. On December 31, 1988 and December 31, 1989, Cheng's promises to pay to Debtor amounts owed to him as of such dates were worthless.

14. As of December 31, 1988 and December 31, 1989, Debtor had no realistic prospect of recovery from Cheng of any of the amounts then due to Debtor.

15. Cheng was unable to obtain a loan in 1988 or 1989 without Debtor's accommodation as a co-maker.

16. Debtor and Cheng signed documents evidencing an intent to enter into a debtor and creditor relationship and each stated orally to witnesses from time to time that a debtor-creditor relationship between them existed.

17. Cheng was in dire financial straits in 1988 and by the end of 1989 was living off loans.

18. Debtor loaned a total of $4,529,349 to Cheng.

Upon consideration of the foregoing facts the Court makes the following Conclusions of Law:

1. This Court has jurisdiction over this matter under 11 U.S.C. Sections 502 and 505, 28 U.S.C. Sections 157 and 1334, the consent of the parties, and the confirmed plan of reorganization of the Debtor.

2. The claim of the California Franchise Tax Board in issue here is presumptively entitled to prima facie validity until Debtor presents admissible evidence which tends to rebut the presumption of validity.

3. The Debtor in this contested matter has presented admissible evidence which tends to rebut the presumption of validity of the claim in issue.

4. The California Franchise Tax Board has the ultimate burden of persuading the court that the facts indicate more probably than not the validity and priority of its claim in issue.

5. A debt for purposes of this contested matter is an obligation to pay money.

6. Cheng agreed to repay to Debtor at least the amounts claimed by Debtor on his 1988 and 1989 returns.

7. A debt becomes deductible for the purposes of this contested matter when it becomes worthless.

8. A debt becomes worthless when there is no reasonable possibility of repayment and there are reasonable grounds for abandoning any hope of repayment in the future.

9. Cheng was indebted to Debtor in the amounts and at the times claimed by Debtor, and such debts were worthless on December 31, 1988 and December 31, 1989 as claimed by Debtor.

10. The California Franchise Tax Board has had an adequate opportunity for discovery. The only evidence offered has been offered by the Debtor. The testimony of Leslie Szutenbach and John Haegen in their depositions establish the existence and amount of loans claimed by the Debtor. The testimony of Leslie Szutenbach, the declaration of Karen Joyce and the documents offered by the Debtor, including the admissions of Cheng, establish that Cheng was insolvent on December 31, 1988 and December 31, 1989 and that there was no reasonable prospect of recovery of the loans in issue on those dates. The evidence offered by the Debtor is not controverted by the California Franchise Tax Board. Accordingly the Court concludes that there is no issue of material fact raised by the evidence before the Court which is in reasonable dispute.

11. No material conclusion of law is in reasonable dispute.

12. A judgment should be entered denying the claims of the California Franchise Tax Board in issue and determining that Debtor has no liability for the amounts claimed.

Dated this 10th day of August 1993.

/s/ Peter W. Bowie
United States Bankruptcy Judge

APPENDIX "D"

Section 8, Clause 4. Naturalization and Bankruptcy

To establish an uniform Rule of Naturalization, and uniform Laws on the subject of Bankruptcies throughout the United States;

* * *

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§ 1254. Courts of appeals; certiorari; certified questions

Cases in the courts of appeals may be reviewed by the Supreme Court by the following methods:

(1) By writ of certiorari granted upon the petition of any party to any civil or criminal case, before or after rendition of judgment or decree;

(2) By certification at any time by a court of appeals of any question of law in any civil or criminal case as to which instructions are desired, and upon such certification the Supreme Court may give binding instructions or require the entire record to be sent up for decision of the entire matter in controversy.

(June 25, 1948, ch 646, § 1, 62 Stat. 928; June 27, 1988, P. L. 100-352, § 2(a), (b), 102 Stat. 662.)

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§ 505. Determination of tax liability

(a)(1) Except as provided in paragraph (2) of this subsection, the court may determine the amount or legality of any tax, any fine or penalty relating to a tax, or any addition to tax, whether or not previously assessed, whether or not paid, and whether or not contested before and adjudicated by a judicial or administrative tribunal of competent jurisdiction.

(2) The court may not so determine –

(A) the amount or legality of a tax, fine, penalty, or addition to tax if such amount or legality was contested before and adjudicated by a judicial or administrative tribunal of competent jurisdiction before the commencement of the case under this title; or

(B) any right of the estate to a tax refund, before the earlier of –

(i) 120 days after the trustee properly requests such refund from the governmental unit from which such refund is claimed; or

(ii) a determination by such governmental unit of such request.

(b) A trustee may request a determination of any unpaid liability of the estate for any tax incurred during the administration of the case by submitting a tax return for such tax and a request for such a determination to the governmental unit charged with responsibility for collection or determination of such tax. Unless such return is fraudulent, or contains a material misrepresentation, the trustee, the debtor, and any successor to the debtor are discharged from any liability for such tax –

(1) upon payment of the tax shown on such return, if –

(A) such governmental unit does not notify the trustee, within 60 days after such request, that such return has been selected for examination; or

(B) such governmental unit does not complete such an examination and notify the trustee of any tax due, within 180 days after such request or within such additional time as the court, for cause, permits;

(2) upon payment of the tax determined by the court, after notice and a hearing, after completion by such governmental unit of such examination; or

(3) upon payment of the tax determined by such governmental unit to be due.

(c) Notwithstanding section 362 of this title, after determination by the court of a tax under this section, the governmental unit charged with responsibility for collection of such tax may assess such tax against the estate, the debtor, or a successor to the debtor, as the case may be, subject to any otherwise applicable law.

(Nov. 6, 1978, P. L. 95-598, Title I, § 101, 92 Stat. 2582; July 10, 1984, P. L. 98-353, Title III, Subtitle H, § 447, 98 Stat. 374.)

Rule 3001
PROOF OF CLAIM

(a) Form and Content. A proof of claim is a written statement setting forth a creditor's claim. A proof of claim shall conform substantially to the appropriate Official Form.

(b) Who May Execute. A proof of claim shall be executed by the creditor or the creditor's authorized agent except as provided in Rules 3004 and 3005.

(c) Claim Based on a Writing. When a claim, or an interest in property of the debtor securing the claim, is based on a writing, the original or a duplicate shall be filed with the proof of claim. If the writing has been lost or destroyed, a statement of the circumstances of the loss or destruction shall be filed with the claim.

(d) Evidence of Perfection of Security Interest. If a security interest in property of the debtor is claimed, the proof of claim shall be accompanied by evidence that the security interest has been perfected.

(e) Transferred Claim.

(1) *Transfer of Claim Other Than for Security Before Proof Filed.* If a claim has been transferred other than for security before proof of the claim has been filed, the proof of claim may be filed only by the transferee or an indenture trustee.

(2) *Transfer of Claim Other Than for Security After Proof Filed.* If a claim other than one based on a publicly traded note, bond, or debenture has been transferred other than for security after the proof of claim has been

filed, evidence of the transfer shall be filed by the transferee. The clerk shall immediately notify the alleged transferor by mail of the filing of the evidence of transfer and that objection thereto, if any, must be filed within 20 days of the mailing of the notice or within any additional time allowed by the court. If the alleged transferor files a timely objection and the court finds, after notice and a hearing, that the claim has been transferred other than for security, it shall enter an order substituting the transferee for the transferor. If a timely objection is not filed by the alleged transferor, the transferee shall be substituted for the transferor.

(3) *Transfer of Claim for Security Before Proof Filed.* If a claim other than one based on a publicly traded note, bond, or debenture has been transferred for security before proof of the claim has been filed, the transferor or transferee or both may file a proof of claim for the full amount. The proof shall be supported by a statement setting forth the terms of the transfer. If either the transferor or the transferee files a proof of claim, the clerk shall immediately notify the other by mail of the right to join in the filed claim. If both transferor and transferee file proofs of the same claim, the proofs shall be consolidated. If the transferor or transferee does not file an agreement regarding its relative rights respecting voting of the claim, payment of dividends thereon, or participation in the administration of the estate, on motion by a party in interest and after notice and a hearing, the court shall enter such orders respecting these matters as may be appropriate.

(4) *Transfer of Claim for Security After Proof Filed.* If a claim other than one based on a publicly traded note,

bond, or debenture has been transferred for security after the proof of claim has been filed, evidence of the terms of the transfer shall be filed by the transferee. The clerk shall immediately notify the alleged transferor by mail of the filing of the evidence of transfer and that objection thereto, if any, must be filed within 20 days of the mailing of the notice or within any additional time allowed by the court. If a timely objection is filed by the alleged transferor, the court, after notice and a hearing, shall determine whether the claim has been transferred for security. If the transferor or transferee does not file an agreement regarding its relative rights respecting voting of the claim, payment of dividends thereon, or participation in the administration of the

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§ 166. Bad debts.

(a) General rule. (1) Wholly worthless debts. There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

(2) Partially worthless debts. When satisfied that a debt is recoverable only in part, the Secretary may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction.

(b) Amount of deduction. For purposes of subsection (a), the basis for determining the amount of the deduction for any bad debt shall be the adjusted basis provided in

section 1011 for determining the loss from the sale or other disposition of property.

(c) Repealed.

(d) Nonbusiness debts. (1) General rule. In the case of a taxpayer other than a corporation –

(A) subsection (a) shall not apply to any nonbusiness debt; and

(B) where any nonbusiness debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 1 year.

(2) Nonbusiness debt defined. For purposes of paragraph (1), the term "nonbusiness debt" means a debt other than –

(A) a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or

(B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

(e) Worthless securities. This section shall not apply to a debt which is evidenced by a security as defined in section 165(g)(2)(C).

(f) Cross references. (1) For disallowance of deduction for worthlessness of debts owed by political parties and similar organizations, see section 271.

(2) For special rule for banks with respect to worthless securities, see section 582.

* * *

ARTICLE 6

Deductions

§ 17201. Determination in accordance with Internal Revenue Code provisions

(a) Part VI of Subchapter B of Chapter I of Subtitle A of the Internal Revenue Code, relating to itemized deductions for individuals and corporations, shall apply, except as otherwise provided.

(b) Part VII of Subchapter B of Chapter I of Subtitle A of the Internal Revenue Code, relating to additional itemized deductions for individuals, shall apply, except as otherwise provided.

(c) Part IX of Subchapter B of Chapter I of Subtitle A of the Internal Revenue Code, relating to items not deductible, shall apply, except as otherwise provided.

Added Stats 1993 ch. 873 § 12 (AB 35), effective October 6, 1993.

Former Sections:

Former § 17201, similar to the present section, was added Stats 1983 ch. 488 § 29, effective July 28, 1983, and repealed Stats 1993 ch. 873 § 11 (AB 35), effective October 6, 1993.

Note – Stats 1993 ch. 878 provides:

SEC. 24. California law with respect to the health insurance deduction for self-employed individuals conforms to Section 162(*l*) of the Internal Revenue Code in Section 17201 of the Revenue and Taxation Code, as modified by Section 1727 [sic] of the Revenue and Taxation Code. The Legislature finds and declares that in order to ease compliance burdens on taxpayers and to avoid unnecessary administrative costs, the Franchise Tax Board shall administer the California provisions in substantially the same manner as the Secretary of the Treasury and the Internal Revenue Service administer Section 162(*l*) of the Internal Revenue Code to reflect the amendments made by Section 13174 of the federal Revenue Reconciliation Act of 1993. Consistent with this purpose and policy, the Legislature further declares its intent that affected taxpayers shall make an adustment for the health insurance deduction for self-employed individuals for California purposes in the same taxable year as the adjustment is made for federal purposes.

* * *

Bankruptcy Rule 9014

CONTESTED MATTERS

In a contested matter in a case under the Code not otherwise governed by these rules, relief shall be requested by motion, and reasonable notice and opportunity for hearing shall be afforded the party against whom relief is sought. No response is required under this

rule unless the court orders an answer to a motion. The motion shall be served in the manner provided for service of a summons and complaint by Rule 7004, and, unless the court otherwise directs, the following rules shall apply: 7021, 7025, 7026, 7028-7037, 7041, 7042, 7052, 7054-7056, 7062, 7064, 7069, and 7071. The court may at any stage in a particular matter direct that one or more of the other rules in Part VII shall apply. An entity that desires to perpetuate testimony may proceed in the same manner as provided in Rule 7027 for the taking of a deposition before an adversary proceeding. The clerk shall give notice to the parties of the entry of any order directing that additional rules of Part VII are applicable or that certain of the rules of Part VII are not applicable. The notice shall be given within such time as is necessary to afford the parties a reasonable opportunity to comply with the procedures made applicable by the order.

Supreme Court, U.S.
FILED
SEP 11 1996
CLERK

No. 96-235

In The

Supreme Court of the United States

October Term, 1995

FRANCHISE TAX BOARD OF
THE STATE OF CALIFORNIA,

Petitioner,

v.

STEPHEN B. MACFARLANE,

Respondent.

**On Petition For Writ Of Certiorari
To The United States Court Of Appeals
For The Ninth Circuit**

RESPONDENT'S BRIEF IN OPPOSITION

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QUESTIONS PRESENTED

If the allocation of burden of proof in litigation of bankruptcy tax claims is important, why did the only two circuits who have addressed the issue since 1898 have to resort to dicta to decide it?

Should this Court review the judgment of the Ninth Circuit Court of Appeals for the question posed by Petitioner even though the judgment should be affirmed because:

(a) Petitioner presented no evidence and therefore affirmance of summary judgment is proper; and

(b) The claim of the Petitioner was not entitled to presumptive validity because it was based solely on an IRS report which was withdrawn by the United States Department of Justice; and

(c) The claim of the petitioner was not entitled to presumptive validity because assessment was barred by 11 U.S.C. § 362(a); and

(d) All Circuits are unanimous that a claimant asserting a claim for taxes incurred after commencement of a bankruptcy case has the burden of proving all elements of its claim; and

(e) It is well settled that any claim in bankruptcy is entitled only to rebuttable presumption validity under F.R.B.P. 3001(f); and

(f) Any result other than the result in the Ninth Circuit would result in potentially at least 53 different burdens of proof applicable in determining tax claims in bankruptcy cases contrary to the uniformity intended by,

QUESTIONS PRESENTED – Continued

among other provisions, 11 U.S.C. §§ 346, 505, 728, 1146 and F.R.B.P. 3001(f); and

(g) The burden of proof rule in a controversy between a tax claimant and a taxpayer is not applicable to the controversy in a bankruptcy case between the tax claimant and other claimants who seek to share the taxpayer's estate; and

(h) The question asserted by Petitioner is not raised by the facts; and

(i) The decisions claimed to be in conflict are not in conflict because one dealt with a federal tax claim and the case at hand deals with a state tax claim in which issues of uniformity are more germane.

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OPINIONS BELOW

Respondent adopts the Petitioner's Statement of Opinions Below.

JURISDICTION

Respondent adopts the Petitioner's Statement of Jurisdiction.

CONSTITUTIONAL PROVISIONS, STATUTES AND RULES INVOLVED

Respondent adopts the Petitioner's Statement of Constitutional Provisions, Statutes and Rules Involved noting that although F.R.B.P. Rule 3001(f) is referenced in Petitioner's Statement, it is not included in Petitioner's Appendix as Petitioner represents at page 2 of its brief. Rule 3001(f) states:

> (f) **Evidentiary Effect.** A proof of claim executed and filed in accordance with these rules shall constitute prima facie evidence of the validity and amount of the claim.

Respondent suggests that the following statutes are also relevant:

11 U.S.C. § 346
11 U.S.C. § 362(a)
11 U.S.C. § 507(a)(8)
11 U.S.C. § 728
11 U.S.C. § 1107(a)
11 U.S.C. § 1146

STATEMENT OF THE CASE

Respondent commenced his bankruptcy case in 1990. The Internal Revenue Service subsequently asserted a claim for income taxes based on an audit report it issued on June 25, 1991. Respondent objected to this claim and the United States Department of Justice accepted as settlement a minor portion of the amount claimed.

Petitioner asserted a claim on April 3, 1992 based solely on the Internal Revenue Service report abandoned by the United States Department of Justice. Respondent objected to Petitioner's claim and filed depositions and declarations of witnesses and 849 pages of documentary evidence. Petitioner submitted no evidence. Respondent also contended that the issue of who has the burden of proof was irrelevant because inasmuch as no assessment had been made because it was barred by 11 U.S.C. § 362(a)[1] and the claim was based solely on an IRS report which had been withdrawn, no state presumption of validity arose and also because no controverted fact was in issue.

Respondent contended that the language in *IRS v. Levy (In re Landbank Equity Corp.)*, 973 F.2d 265 (4th Cir. 1992) (hereafter "*Levy*") was dicta and irrelevant because in that decision no evidence was presented to rebut the tax claim and accordingly the decision was proper under

---

[1] **362. Automatic stay**

(a) Except as provided in subsection (b) of this section, a petition filed under section 301, 302, or 303 of this title . . . operates as a stay. . . .

F.R.B.P. 3001(f) without application of any other burden of proof rule.

The facts to be reviewed are not those with which Petitioner takes considerable license in its statement but rather those found at pages 37 through 42 of Petitioner's Appendix as determined by the bankruptcy court. These facts were found by the Ninth Circuit to be uncontroverted and sufficient under applicable law to support judgment in favor of Respondent. Petitioner's Appendix at 11.

The Petitioner filed a notice of appeal, and the matter was ultimately heard by the district court. On June 29, 1994, the district court entered its judgment and memorandum decision affirming the bankruptcy court's denial of the state's proof of claim and reversing the bankruptcy court's summary determination, holding that genuine issues of material fact existed. Respondent filed a motion for reconsideration of this self-contradictory decision which was denied.

The Petitioner timely appealed to the United States Court of Appeals for the Ninth Circuit and the Respondent filed a cross-appeal. The matter was argued on March 6, 1996. That decision affirmed the holding of the district court which denied the Petitioner's proof of claim and reversed the holding of the district court which had held that genuine issues of material fact existed and remanded to the bankruptcy court for entry of judgment for Respondent on all issues. To obtain a review of that decision the Petitioner has filed its petition with this Court.

REASONS FOR NOT GRANTING THE WRIT

NEITHER THE NINTH CIRCUIT NOR THE FOURTH CIRCUIT HAD TO DECIDE WHO HAD THE BURDEN OF PROOF

In *Levy* the bankruptcy estate presented no evidence. Under F.R.B.P. Rule 3001(f) the claimant therefore wins. That was all that was required.

In the case at hand the estate presented almost a thousand pages of documents and depositions and declarations. The decision to be reviewed found both that there was no controverted fact and that the facts necessary to support a determination of nonliability had been determined.

There is no conflict in decision, only in principle, perhaps due to a failure of advocacy in the Fourth Circuit.

Furthermore, *Levy* recognized that its decision may apply only to federal tax claims inasmuch as it distinguished *California State Board of Equalization v. Official Unsecured Creditors Comm. (In re Fidelity Holding Co., Ltd.)*, 837 F.2d 696, 698 (5th Cir. 1988), which held that as to California state tax claims the federal standard of F.R.B.P. Rule 3001(f) alone applied. Respondent's Appendix at 38.

THERE ARE GROUNDS FOR AFFIRMING THE JUDGMENT OF THE NINTH CIRCUIT INDEPENDENT OF ITS PRONOUNCEMENT ON BURDEN OF PROOF

A prevailing party may "defend its judgment on any ground properly raised below. . . . ", *Washington v. Yakima Indian Nation*, 439 U.S. 463, 476 n. 20, 99 S. Ct. 740, 749 n.

20, 58 L. Ed. 2d 740 (1979); *Dayton Board of Education v. Brinkman*, 433 U.S. 406, 419, 97 S. Ct. 2766, 53 L. Ed. 2d 851 (1977); *Blum v. Bacon*, 457 U.S. 132, 137 n. 5, 102 S. Ct. 2355, 2359 n. 5, 72 L. Ed. 2d 728 (1982); *United States v. New York Telephone Co.*, 434 U.S. 159, 166 n. 8, 98 S. Ct. 364, 369 n. 8, 54 L. Ed. 2d 376 (1977).

As noted at Respondent's Appendix 2-25, Respondent urged that there was no burden of proof issue raised by the record because:

(a) no fact was controverted;

(b) no presumptive validity arose because no assessment was made and the claim was based solely on an IRS audit report abandoned by the United States Department of Justice (Respondent's Appendix 25);

(c) the Petitioner never cited any applicable state standard for burden of proof which applied in the presence of such facts (Respondent's Appendix 24).

As this Court has held, "We do not grant a certiorari to review evidence. . . . " *United States v. Johnson*, 268 U.S. 220, 227, 45 S. Ct. 496, 497, 69 L. Ed. 925 (1925). Petitioner is asking this Court to determine that the burden of proof matters in a decision in which no fact is controverted and in which several independent grounds for affirmance exist. Respondent does not believe that the issue contended to exist is apropos.

THE ISSUE PRESENTED IS NOT ONE OF PRESSING IMPORTANCE

The two decisions contended by Petitioner to be in conflict are the only two on the issue since 1898 to reach the merits and only then when they did not have to.

Furthermore *Levy* ignores the clear historical treatment of claims in bankruptcy as chronicled by the Respondent in the Ninth Circuit.

As Respondent noted before the Ninth Circuit, the law on this issue has been clear for a long time:

> The FTB's ubiquitous citations to *Vanston Bondholders Protective Comm. v. Green*, 329 U.S. 156, 67 S. Ct. 237 (1946) in support of its position fail to quote the most relevant passage from the opinion: "In determining what claims are allowable and how a debtor's assets shall be distributed, a bankruptcy court does not apply the law of the state where it sits." *Id.* at 329 U.S. 162. It should also be noted that in addition to the substantive decisions regarding the paramount nature of federal law in bankruptcy cases, a strong argument can be made that the FTB in filing its claim consented to a federal burden of proof rule. *See also*, E. Martin, *Consent: The Constitutional Basis for Bankruptcy Judge Authority*, 19 Cal. Bankr. J. 1 (1991).

Respondent's Appendix at 29.

Ironically, in *American Dredging Co. v. Miller*, 510 U.S. 443, 114 S. Ct. 981, 988, 127 L.Ed. 2d 285 (1994), cited by Petitioner, this Court noted that the federal burden of proof rule in admiralty has preempted contrary state rules since before 1942. Admiralty and bankruptcy have often been noted to have comparable considerations of uniformity and purpose.

THE DECISION OF THE NINTH CIRCUIT WAS CORRECT, FAIR AND ANY OTHER ALTERNATIVE WOULD CREATE CHAOS

As argued in the Ninth Circuit, Respondent's Appendix 27-28, the burden of proof rule which applies between a taxpayer and a tax claimant does not apply when the controversy is between the tax claimant and other creditors of the taxpayer competing for a portion of the assets of the bankruptcy estate of the taxpayer. All should be similarly situated.

The invalidity of Petitioner's allegation that the burden should be placed on the estate because it has access to evidence is demonstrated by *Levy* in which the estate lost because the trustee of the estate could present no evidence to rebut the claim in issue. Respondent's Appendix 27-28. Petitioner's assertion that trustees in bankruptcy have greater access to information than a taxing agency when the trustees assume control over the chaotic affairs of a bankrupt is generally not a reality. This circumstance in *Levy* supports Respondent's position that burden of proof rules applicable outside of bankruptcy do not apply in bankruptcy because the parties in interest are different. In a bankruptcy case the other creditors, rather than the debtor, are the persons in interest in the claims allowance process. Either a trustee, or a debtor in possession acting as a trustee pursuant to 11 U.S.C. § 1107(a),[2] represents the other creditors in this

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[2] 1107. Rights, powers, and duties of debtor in possession

(a) [A] debtor in possession shall have all the rights . . . and powers, and shall perform all the functions and duties . . . of a trustee serving in a case under this chapter.

process. This Court has always looked to the real parties in interest in controversies. For instance, in *Guidry v. Sheet Metal Workers Pension Fund*, 493 U.S. 365, 110 S. Ct. 680, 107 L. Ed. 2d 782 (1990), this Court noted that "the malefactor often is not the only beneficiary of the pension" in precluding an equitable exception to ERISA prohibition of alienation of a pension plan account. This result was subsequently applied in a bankruptcy context in *Patterson v. Shumate*, 504 U.S. 753, 112 S. Ct. 2242, 119 L. Ed. 2d 519 (1992). This issue was raised in the Ninth Circuit. Respondent's Appendix 40-43.

Whenever the tax claimant was intended to have an advantage, as in priority of a claim once established, the Code has stated the advantage. 11 U.S.C. § 507(a)(8).[3] It

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[3] **507. Priorities**

(a) The following expenses and claims have priority in the following order:

. . .

(8) Eighth, allowed unsecured claims of governmental units, only to the extent that such claims are for – . . . .

(A) a tax on or measured by income. . . .

(B) a property tax assessed before the commencement of the case and last payable without penalty after one year before the date of the filing of the petition;

(C) a tax required to be collected or withheld and for which the debtor is liable in whatever capacity;

(D) an employment tax on a wage. . . .

(E) an excise tax on – . . . .

(F) a customs duty. . . .

(G) a penalty . . . for actual pecuniary loss.

is well established that the burden of proof in establishing nondischargeability of a tax is on the taxing agency. *Grogan v. Garner*, 498 U.S. 279, 111 S. Ct. 654, 112 L. Ed. 2d 755 (1991). Since it is clear that a tax claimant has the burden of proof as to both priority and nondischargeability, it would be inconsistent to hold that it should be treated any differently as to other merits of its claim.

The Bankruptcy Code was intended to provide for uniformity of state taxation determination in many ways, see, e.g., 11 U.S.C. §§ 346,[4] 505,[5] 728[6] and 1146[7] in order to provide for uniformity throughout the country. The rule argued by Petitioner could conceivably require tax claims to turn on 50 state standards and each of the three federal standards each of which are slightly different from each other.

As Respondent argued to the Ninth Circuit, the decision of the Ninth Circuit is also consistent with the unanimous decisions of all Courts regarding taxes incurred

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[4] **346. Special tax provisions**

(a) Except to the extent otherwise provided in this section, subsections (b), (c), (d), (e), (g), (h), (i), and (j) of this section apply notwithstanding any State or local law imposing a tax. . . .

[5] Petitioner's Appendix 44-45.

[6] **728. Special tax provisions**

(a) For the purposes of any State or local. . . .

(b) Notwithstanding any State or local law imposing a tax on or measured by income. . . .

[7] **1146. Special tax provisions**

(a) For the purposes of any State or local law imposing a tax on or measured by income. . . .

after the commencement of the bankruptcy case which are clearly governed solely by a federal standard. Respondent's Appendix 26-27.

CONCLUSION

The Petition for Writ of Certiorari should be denied because the conflict claimed does not exist, the question contended is not raised by the facts, there is no showing that there is any state standard of proof rule applicable to these facts, the decision sought to be reviewed is correct and fair and a contrary decision would be contrary to orderly national administration of bankruptcy law.

Respectfully submitted,

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UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

In re STEPHEN B. MACFARLANE Debtor.	CASE NOS. 94-56064 94-56065
FRANCHISE TAX BOARD OF THE STATE OF CALIFORNIA, Appellant/Cross Appellee/Creditor, -vs- STEPHEN B. MACFARLANE, Appellee/Cross Appellant/Debtor	[DC # CV-93 01435-JSR So. Dist. San Diego]

COMBINED CROSS APPEAL OPENING AND APPEAL REPLY BRIEFS OF STEPHEN B. MACFARLANE

APPEAL FROM A JUDGMENT OF THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF CALIFORNIA

Honorable John S. Rhoades
United States District Judge

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2. If the district court correctly characterized the judgment of the bankruptcy court as a summary judgment, was there any controverted material issue of fact which prevented a valid summary judgment? This is reviewed *de novo*.

Reply to FTB Appeal

3. Was William Cheng ("Cheng") obligated to repay to Debtor the amounts of $1,400,000 and $2,028,141 advanced by Debtor to Cheng during 1988 and 1989 respectively? This is reviewed under the clearly erroneous standard.

4. Did Cheng's obligations to repay the 1988 and 1989 advances become worthless in 1988 and 1989 respectively? This is reviewed under the clearly erroneous standard.

5. Since FTB never made an assessment of the tax in question, is there any presumption of validity under state law? This is reviewed *de novo*.

6. Is a FTB proposed assessment based on an IRS' audit report which was abandoned by the U.S. Department of Justice entitled to presumptive validity? This is reviewed *de novo*.

7. Should a tax claimant be treated differently from any other claimant in the absence of any bankruptcy law or rule giving it special treatment? This is reviewed *de novo*.

STANDARD OF REVIEW

Normally review of disposition of summary judgment motions is *de novo*. The issue of whether a judgment is a summary judgment is reviewed *de novo*. This Court reviews such matters *de novo* because it is in as good a position to do so as was the district court. *In re Marquam Inv. Corp.*, 942 F.2d 1462, 1465 (9th Cir. 1991) (function of this court in reviewing district court reversal of bankruptcy court); *In re Dominguez*, 51 F.3d 1502, 1506 (9th Cir. 1995).

The district court noted that on July 12, 1993 the bankruptcy court had before it both an objection and a motion for summary judgment. Supp. ER9 and DCR11 at 6. At the hearing on the FTB's claim on March 15, 1993, the bankruptcy court continued the hearing to July 12, 1993 in order to allow the FTB an opportunity to conduct discovery and offer evidence and stated that an evidentiary hearing would be held. Supp. ER4 and DCR4 at 170.

On June 11, 1993 the Debtor filed a motion for summary determination of the claim by either evidentiary hearing or by summary judgment as the court considered appropriate. ER5 and DCR4 at 121-122. At the hearing on July 12, 1993 the court comprehensively addressed the merits of the evidence without addressing the motion for summary judgment. ER7; DCR4 at 71-81. The Debtor also noted in brief that the *de novo* standard of review should not be applied in reviewing the judgment of the bankruptcy court based on an uncontested evidentiary hearing to which no objection was made after an opportunity for discovery had been afforded. Supp. ER8 and DCR7 at 3. Finally the Debtor urged the bankruptcy court to hold that the Debtor had supported its objection by a preponderance of the evidence. ER5 and DCR4 at 128.

The characterization by the district court of the judgment of the bankruptcy court should be reviewed *de novo*. However, the findings of fact of the bankruptcy court should be reviewed under the clearly erroneous standard whether or not they were pursuant to the summary judgment motion. In reviewing a summary judgment, this Court in *Ojai Unified School District v. Jackson*, 4 F.3d 1467, 1472 (9th Cir. 1993) stated: "[T]he district court essentially conducted a bench trial based on a stipulated record. Accordingly, we conclude that, because the district court already has performed a *de facto* bench trial, a remand for trial would serve no useful purpose in this case. The parties concede that the district court had before it all of their evidence regarding the issues in dispute; the record before us is therefore complete."

Ojai involved a review of an agency determination and applied the standard of review appropriate for that

review rather than a *de novo* standard. On facts more similar to Debtor's case, this Court in *Kreisner v. City of San Diego*, 988 F.2d 883, 887n.3 (9th Cir. 1993) applied the clearly erroneous standard in an appeal from a summary judgment:

> The dissent states because we are reviewing the district court's grant of summary judgment we should view the evidence in the light most favorable to Kreisner, rather than adopt the findings of fact of the district court. . . . . Here, the district court made findings of fact after holding an evidentiary hearing and taking testimony in open court. . . . . Kreisner did not object to the holding of an evidentiary hearing, nor is there any indication that he did not have sufficient notice to present his case. . . . [T]here is no reason to depart from the clearly erroneous standard of review that we apply to findings of fact following an evidentiary hearing.

The rationale for such appellate review is stated in the Federal Judicial Center monograph on summary judgment which explains the procedure for summary judgment in a bench trial as follows:

> [W]hen the question for decision concerns drawing inferences from undisputed evidence, or interpreting and evaluating evidence to derive legal conclusions, a trial may not add to the judge's ability to decide. Thus, when the disputed issue is one of ultimate fact, a bench trial is often unnecessary; the considerations that militate in favor of trial if it is to a jury do not apply. . . . A court may determine that a full trial would add nothing to the paper record and, after proper notice, decide a case on that record,

> making a decision on a "trial without witnesses" rather than on summary judgment.

W. Schwarzer, et al., *The Analysis and Decision of Summary Judgment Motions* 39-40 (1991).

Debtor notes that the application of the clearly erroneous standard obviates the necessity to resolve the *Bonner* and *Vylene* finality issue noted in the statement of jurisdiction here.

The findings of fact of the bankruptcy court should be affirmed, as they were by the district court, unless this Court is left with "the definite and firm conviction that a mistake has been committed." If the bankruptcy court's "account of the evidence is plausible in light of the record viewed in its entirety, the court of appeals may not reverse it even though convinced that had it been siting as the trier of fact, it would have weighed the evidence differently." *Wolf v. C.I.R.*, 4 F.3d 709, 712-713 (9th Cir. 1993).

STATEMENT OF THE CASE

On June 25, 1991 the IRS issued an audit report which determined that deductions for uncollectible debts due from William Cheng in the amount of $1,400,000 for 1988 and $2,028,141 for 1989 should be disallowed and Debtor should pay income taxes, penalties and interest as of that date in the amount of $1,239,750 for 1988 and 1989. Supp. ER6 and DCR4 at 597-610. The court may take judicial notice that interest on this amount as of October 16, 1992 would add approximately $100,000 to the amount due to the IRS in addition to the 1991 amount. Accordingly as of

October 16, 1992 the amount due to the IRS was about $1,339,750.

The debtor contested the IRS claim in the bankruptcy court. On October 16, 1992 the U. S. Department of Justice conceded all but $250,000 of the IRS' $1,339,750 claim. Supp. ER6 and DCR4 at 612-614. In the meantime, on April 3, 1992 the FTB issued its notice that debtor owed $410,838 to the FTB for 1988 and 1989 income taxes, interest and penalties based solely on the IRS audit report. Supp. ER6 and DCR4 at 576, 595-596. This notice was expressly based solely upon the IRS audit report. *Id.* The FTB filed its claims in the bankruptcy court beginning in June 1992 based on that notice. Supp. ER6 and DCR4 at 576.

On January 6, 1993 Debtor's Chapter 11 plan was confirmed. ER15 at page 19 docket entry 180. On January 11, 1993 the debtor filed his objection to the FTB's claim. ER3(partial); DCR4 at 672-1154. On February 3, 1993 the FTB filed its response and set a hearing for March 15, 1993. ER4; DCR4 at 579-671. On March 2, 1993 the Debtor filed his response to the FTB's response for the hearing on March 15, 1993. Debtor raised a number of evidentiary issues. Supp. ER4 and DCR4 at 209-210.

On March 15, 1993 the bankruptcy court conducted a hearing on the Debtor's objection to the FTB claim. Supp. ER4 and DCR4 at 169-173. The court ruled that the FTB's claim was prima facie valid but that the Debtor had provided competent evidence that debts existed in 1988 and 1989 and that the debts were worthless in 1988 and 1989 rebutting the presumption of validity of the FTB claim. The court then adjourned the hearing to July 12,

1993 for an evidentiary hearing to allow the FTB to conduct discovery and offer evidence.

The FTB chose to forego discovery and offered no evidence. On June 11, 1993 the Debtor filed a motion for summary determination of the claim noting the lack of any activity by the FTB, ER5 and DCR4 at 122, and in the alternative requested that the objection to the claims of the FTB be determined on the merits on the evidence submitted. ER5 and DCR4 at 122 lines 1-3. The FTB did not respond with a statement of controverted facts or conclusions of law. It responded with a memorandum which dealt primarily with burden of proof issues. ER5 and DCR4 at 88. Debtor's position was that he had proved that loans were made to William Cheng, that they became worthless in the years claimed, that he did not have to prove that there was no evidence in existence which could lead to an alternative factual result which is apparently what the FTB argues, and that although he raised the burden of proof issue in his opening pleadings as the case had progressed the issue had become irrelevant because there were no reasonably controverted facts.

At the hearing on July 12, 1993 the bankruptcy court comprehensively addressed the issues on the merits of the evidence on the basis of the objection without addressing the summary judgment motion. ER7; DCR4 at 70-83. The court went on to criticize the FTB for failing to conduct any discovery to obtain evidence which controverted the evidence offered by the Debtor. *Id.* In neither the bankruptcy court, the district court nor here has the FTB contended that William Cheng did not obtain from Debtor $1,400,000 in 1988 and $2,028,141 in 1989. The FTB has contested only characterization of these amounts as

debts and the time of their worthlessness. The bankruptcy court's judgment, findings and conclusions were entered August 10, 1993.

The FTB filed its notice of appeal August 19, 1993. ER9. On June 29, 1994 the district court filed its memorandum decision and judgment reversing the judgment of the bankruptcy court which the district court characterized as a summary judgment, affirmed the bankruptcy court's findings as not clearly erroneous, and affirmed the court's conclusions of law. Supp. ER9. Both parties timely appealed. ER9 and Supp. ER3.

ARGUMENT

Summary

The proper standard of review of a judgment resulting from an evidentiary hearing in which all of the facts are developed is the clearly erroneous standard whether or not the hearing resulted from a motion for summary judgment. The district court was wrong when it applied a *de novo* standard of review. It was also wrong in characterizing the judgment as a summary judgment.

Even if the bankruptcy court's judgment was a summary judgment, the four aspects of evidence cited by the district court were taken out of context. The inferences drawn by the district court were not reasonable in light of all of the evidence before it. Accordingly even after a *de novo* review the district court should have affirmed.

It is uncontested that the amounts in issue were advanced to Cheng from Debtor in 1988 and 1989. All of the testimony of percipient witnesses corroborated by

inches of checks which bear notations that they are "loans", loan documents and agreements the composition and execution of which was supervised by Cheng's lawyer and statements under oath by Cheng admitting his obligation to debtor indicate the existence of a debt. The testimony of Cheng's personal bookkeeper and his office manager who managed both his affairs and debtor's affairs corroborated by his bankruptcy and subsequent valuation of his most significant asset at $2,500 amply demonstrate that at the end of 1988 and 1989 Cheng could not repay the loans. The evidence also indicates it would have been useless to pursue collection.

The Court need not resolve the issue raised by the FTB regarding the holding by the bankruptcy and district courts that the FTB is held to the same burden of proof in proving its claim which is applicable to all creditors in bankruptcy cases. The evidence is clear that even if the debtor had the burden of persuasion, he carried it. The FTB introduced no evidence and made no evidentiary objections. *It cites no relevant state standard of burden of proof after devoting more than half of its brief to an analysis of why the state standard is not preempted by federal law.* Furthermore, inasmuch as no state assessment was ever made, there is no presumptively valid assessment, and since the FTB claim was based only on an IRS report abandoned by the U.S. Department of Justice, the claim has no presumptive validity.

If the Court does decide the burden of persuasion issue, then it should note that the Supreme Court has held that the burden of proof imposed on anyone, including a tax claimant, to prove fraud in an objection to dischargeability proceeding, is different from, and less

than, the burden of proof imposed on a tax claimant outside of bankruptcy court in the assertion of fraud. The fulfillment of federal objectives mandates burdens of proof in bankruptcy cases different from other civil cases. In some instances, this burden on the government, as in the case of fraud, is lighter, and in others, as in the determination as to how the debtor's assets are to be divided among his creditors, it is heavier because all claimants should conduct their contest on a level playing field. No contrary rule is explicitly ordained. The Fifth Circuit has twice so held. The Fourth Circuit's decision to the contrary does not withstand close scrutiny and in any event was a dictum. This Court should also note that all courts agree that the holder of a tax claim arising during a bankruptcy case is not entitled to the benefit of the burden of proof applicable outside of bankruptcy court.

It is perfectly consistent with bankruptcy policy to require a tax claimant to prove entitlement in a bankruptcy case for a payment of tax from the estate, yet to the extent it is not collected from the estate and not discharged, it can be collected from the bankrupt debtor in a proceeding in which the bankrupt has the burden of proof.

Did the district court erroneously characterize the judgment of the bankruptcy court as a summary judgment subject to de novo review?

Debtor has briefed this issue of his cross appeal at pages 8 and 9 of this brief.

If the district court correctly characterized the judgment of the bankruptcy court as a summary judgment, was there a controverted material issue of fact which prevented a valid summary judgment?

The district court in reviewing the record concluded that four aspects of debtor's evidence indicated a genuine issue for trial. Supp. ER9 and DCR11 at 18-20. These are: debtor's statement Cheng did not have permission to use the debtor's money for the purposes for which it was used; debtor discussed tax shelters with Cheng; debtor couldn't distinguish loans from investments; some of the loan documents don't have repayment dates, don't bear interest rates and are not secured.

The inferences to be drawn from the evidence in favor of the FTB to defeat summary judgment must be reasonable. The permission and investment out of context statements were from two lines in 126 pages of testimony. Considering the deposition as a whole it was apparent that the debtor had loaned money to Cheng during 1988 and 1989 and that the debtor considered a loan an investment. Debtor testified that even if a bank loaned money to him the bank would be investing in him. ER6 at 135-136; DCR4 at 356-357. The only tax shelter discussion related to 1981 and 1983. ER6 at 35; DCR4 at 255-257. Neither the district court nor the FTB cited any evidence regarding tax shelters relating to the 1988 or 1989 loans. The bankruptcy court expressly noted that there was no connection shown between the tax shelters and the loans in question. ER7 and DCR4 at 77 lines 17-21. *The misrepresentation of the facts in this regard at pages 25-26 of the FTB's brief was recognized by the bankruptcy court.* The loan documents criticized by the district court, Supp. ER9 and

DCR11 at 20, were addendums to a letter loan agreement from Cheng's lawyer which clearly specified all indicia of a loan required by any criteria. Supp. ER5 and DCR4 at 549-550. The only effect of these addendums was to change one term in the letter agreement. They also related to an extensive loan agreement. Supp. ER7 and DCR4 at 1004-1017.

Arrayed against these four out of context references was all of the other evidence regarding existence of debt and worthlessness discussed *infra*.

Debtor suggests that construing the entirety of the record the only reasonable conclusion one can come to is that Cheng borrowed during 1988 and 1989 not only the amounts in issue, but more than that amount, and that the loans made during 1988 and 1989 were worthless at the end of each of these years. Also, as pointed out *infra*, even if these loans were investments, they clearly were made for profit and if worthless would result in a capital loss which is what debtor claimed. This issue was raised in bankruptcy court by the debtor. ER5 and DCR4 at 128. Whether the loss occurs under I.R.C. 165 or 166 is not a distinction with a difference here. Because a judgment may be affirmed on any basis which appears from the record, the district court should have affirmed the judgment of the bankruptcy court.

Was William Cheng ("Cheng") obligated to repay to Debtor the amounts of $1,400,000 and $2,028,141 advanced by Debtor to Cheng during 1988 and 1989 respectively? Did Cheng's obligations to repay the 1988 and 1989 advances become worthless in 1988 and 1989 respectively?

The evidence offered by the Debtor, to which no evidentiary objections from the FTB were made notwithstanding the FTB's complaints about hearsay in its brief, included:

1. Leslie Szutenbach worked with Debtor and Cheng in all aspects of their business affairs during 1988 and 1989 and is a percipient witness with personal knowledge of such affairs and is the custodian of the documents offered and the person in the course of whose business the documents were prepared on the dates shown on them. Supp. ER6 and DCR4 at 736-778, 837-838, 852, 854(top), 855, 857, 868(top); Supp. ER7 and DCR4 at 874, 877, 882(top), 884(top), 887(top), 888-891, 892(top), 896, 897, 907, 914-918, 1017 and 1027.

2. By December 31, 1988 Cheng had obtained at least $1,632,500 from Debtor and promised to repay this amount. Supp. ER6 and DCR4 at 701, 712, 737, 753, Supp. ER7 and DCR4 at 916-918, 1028-1030, 1033 and 1038.

3. In 1989 Cheng obtained at least $2,224,077 from Debtor and promised to repay this amount. Supp. ER6 and DCR4 at 701, 702; Supp. ER7 and DCR4 at 1028 and 1038.

4. On December 31, 1988 and December 31, 1989 Cheng's promises to pay were worthless. Supp. ER6 and DCR4 at 701 and 702.

5. Cheng knew when he prepared Debtor's 1988 and 1989 federal income tax returns that he could not repay these amounts and therefore caused Debtor's 1988 and 1989 federal income tax returns to report bad debt losses for $1,400,000 for 1988 and $2,028,141 for 1989. Supp. ER6 and DCR4 at 743-744 and 702.

6. In April 1991 Cheng commenced a bankruptcy case under Chapter 13 of Title 11 U.S.C. and his case was converted to Chapter 7 in May 1991. Supp. ER6 and DCR4 at 702 and 703.

7. Cheng's bankruptcy estate has little or no value. Supp. ER6 and DCR4 at 702, 723 and 725.

8. The primary asset of his estate was stock in Cheng Information Systems, Inc., all of the property of which was sold by CIS' bankruptcy trustee for $2,500. Supp. ER6 and DCR4 at 702 and 725.

9. As of December 31, 1988 and December 31, 1989 Macfarlane had no realistic prospect of recovery from Cheng of any of the amounts then due to Macfarlane. Supp. ER6 and DCR4 at 702.

10. John Haegen and Leslie Szutenbach assisted in the preparation of Debtor's 1988 and 1989 tax returns. Supp. ER5 and DCR4 at 316-317; Supp. ER7 and DCR4 at 1026 and 1028. John Haegen was a custodian of the records which evidence the loans and summarized them. Supp. ER7 and DCR4 at 1026-1034. Summary at Supp. ER7 and DCR4 at 1038 with detail appended. Supp. ER5 and DCR4 at 316-317, 332 line 1.

11. Debtor gave Cheng a general power of attorney in 1983, Supp. ER5 and DCR4 at 290-294, and 418 to 421,

and numerous special powers of attorney. Supp. ER5 and DCR4 at 275-289.

12. Cheng signed Debtor's 1988 and 1989 returns as their preparer. Supp. ER5 and DCR4 at 272, 312, 325, 423, and 471.

13. Debtor claimed a $1,400,000 bad debt for 1988, Supp. ER5 and DCR4 at 433, and a $2,028,141 bad debt for 1989. Supp. ER5 and DCR4 at 516.

14. Leslie Szutenbach was a percipient witness for all of the circumstances surrounding the loans from Debtor to Cheng. Supp. ER5 and DCR4 at 262-264, 266, 267, 274.

15. Debtor and Cheng signed documents evidencing an intent to enter into a debtor and creditor relationship. Supp. ER5 and DCR4 at 350, 351, 358 through 364, and 547 through 559. See also Supp. ER6 and DCR4 at 772, 775 and Supp. ER7 and DCR4 at 1000-1018.

16. Cheng was in dire financial straits in 1988 and by the end of 1989 was living off loans. Supp. ER5 and DCR4 at 560-564.

17. Cheng managed all of Debtor's property and affairs and Debtor trusted Cheng for all financial advice. Supp. ER5 and DCR4 at 252-254, 275, and in particular, 298 through 311. Debtor had a mental breakdown in 1980 or 1981, and after that Debtor relied on Cheng to conduct his affairs. Supp. ER5 and DCR4 at 245-248.

18. Debtor loaned $2,047,232 to Cheng in 1989. Supp. ER5 and DCR4 at 337-338.

19. Debtor loaned a total of $4,529,349 to Cheng. Supp. ER5 and DCR4 at 412.

The substantive tax law issues have been decided based on federal law because of California's conformity to federal law on this subject. In this regard it is important to note the Debtor has noted that the loss claimed by Debtor was a nonbusiness bad debt, or capital, loss. Consequently the FTB's emphasis on characterizing the loan in question as an "investment" does not change the income tax result if worthlessness nevertheless occurred in 1988 and 1989 as contended by Debtor. The tax in question arose from capital gains which were offset by the capital loss at issue. Supp. ER6 and DCR4 at 598-610; ER5 and DCR4 at 128. The bankruptcy court at the July 15, 1993 hearing systematically addressed the criteria for deductibility of bad debt losses listed by the FTB in the context of the evidence offered by the Debtor. As the court noted, the amounts involved were not in issue. The bankruptcy court started its analysis with the letter of January 12, 1987, Supp. ER5 and DCR4 at 547-548, which clearly reflected a secured loan transaction in the amount of $250,000. On February 26, 1987 there is memorialization of an offer by Debtor to lend to Cheng an amount of $500,000 witnessed by Leslie Szutenbach. Supp. ER5 and DCR4 at 549. This was increased to $750,000 on May 6, 1987. Supp. ER5 and DCR4 at 550. Debtor wrote checks to Cheng for the loans. Supp. ER5 and DCR4 at 551-556. Cheng signed promissory notes. Supp. ER5 and DCR4 at 557-559. Some of these same documents, and additional documents, are at Supp. ER7 and DCR4 at 1004-1018. On July 31, 1988 Debtor and Macfarlane entered into a loan agreement which acknowledged loans of up to $1,250,000

and granted Debtor the right to exchange his right to repayment from Cheng to a right of repayment from a corporation upon the occurrence of events which never transpired and expressly acknowledged that the agreement did not require the Debtor to enter into such an exchange or to limit Cheng's obligation to repay the debt to Debtor. Supp. ER7 and DCR4 at 1004-1017. At Supp. ER7 and DCR4 at 1009 is a letter from Cheng's lawyer who characterized the transactions involved as loans by Debtor to Cheng. In addition to these documents are the checks all of which were designated as loans to Cheng by Debtor and Cheng and summarized by Szutenbach in her declaration and deposition and by John Haegen in his summary of the net checks written to Cheng as loans from Debtor. As to Haegen, see Supp. ER7 and DCR4 at 1038. As noted, the amounts are not in issue and the intent to create a debtor-creditor relationship is well established by Cheng's bankruptcy schedules which show him indebted to Debtor in the amount of $2,939,722 and as owning all of the stock of Cheng Information Systems, by the declaration of Szutenbach and by her deposition and by the Debtor's deposition which include as exhibits the many documents which evidence a debtor-creditor relationship and by the Debtor's tax returns prepared by Cheng and by Cheng's own statements reflected in the depositions and declarations in the record. Cheng's bankruptcy schedules also indicate that there were other lenders loaning money to him during the periods in issue contrary to the FTB's argument that Macfarlane was the only lender. Supp. ER6 and DCR4 at 708-714.

The evidence regarding Cheng's inability to repay these loans as of the end of 1988 and 1989 is uncontradicted. His personal bookkeeper's declaration substantiates his inability to repay. Supp. ER6 and DCR4 at 560-564. He repeatedly stated to Szutenbach than [sic] he could not repay. Supp. ER6 and DCR4 at 743 lines 19-20 and 744 lines 2 and 13. The assets of his only significant asset, Cheng Information Systems, sold for $2,500. Supp. ER6 and DCR4 at 702 and 725. He prepared and signed as preparer the Debtor's tax returns in which he admitted the existence of the debts at issue here and their worthlessness. Supp. ER5 and DCR4 at 423 and 471. Cheng's admissions in this record are uncontradicted. The FTB's inordinate reliance on the circumstance that Cheng had Debtor's power of attorney doesn't contradict any evidence offered by Debtor; it simply confirms, as the bankruptcy court indicated, that Cheng had the authority to carry out the agreements or otherwise to loan the Debtor's funds. As to the FTB's argument that the loans had to have value when made, the Debtor argued that loans can become worthless when made as indicated by the IRS' policy because debts are created both by law and by contract. Supp. ER4 and DCR4 at 214-216. The bankruptcy court stated that was not a problem because at least at the time the loan was made it could have been repaid with the loan proceeds.

As to the FTB's statement on page 28 (bottom) of its brief, that there is "absolutely no evidence . . . that Cheng ever attempted to repay Macfarlane," this is not absolutely true. John Haegen's summary of loans to Cheng was a summary of "net" loans because Cheng did make payments to Macfarlane in 1988. Supp. ER6 and DCR4 at

788; Supp. ER7 and DCR4 at 1038, 1041. This misrepresentation is similar to statements such as the one on page 29 (bottom) of the FTB brief that "the only evidence to support Cheng's inability to repay Macfarlane's cash advances was a hearsay statement from Szutenbach, a former Cheng employee. . . . " As the record amply shows, Szutenbach was Cheng's office manager and her initials are on many of the significant documents in evidence. She also was in charge of Macfarlane's affairs. The FTB made no hearsay objection. But her statement is not the only evidence. The FTB overlooks the declaration of Cheng's personal bookkeeper who had percipient personal knowledge of his financial affairs, the inferences one can gather from Cheng's bankruptcy schedules, and his admissions. See discussion in the preceding paragraph.

The FTB's reliance on a requirement of an "identifiable event" rendering the loan worthless in making the claim, Supp. ER6 and DCR4 at 576 lines 27-28, and in its brief, is simply not the law. There does not have to be an identifiable event; the taxpayer must simply persuade the court that the debt became worthless at the necessary time.

Debts are wholly worthless when there are reasonable grounds for abandoning any hope of repayment in the future, *Dallmeyer v. Commissioner*, 14 T.C. 1282, 1292 (1950), and it could thus be concluded that they have lost their "last vestige of value." *Bodzy v. Commissioner*, 321 F.2d 331, 335 (5th Cir. 1963). But a taxpayer need not be "an incorrigible optimist." *United States v. S.S. White Dental Manufacturing Co.*, 274 U.S. 398, 403, 47 S. Ct. 598, 600 (1927). This will usually entail proof of the existence of

identifiable events which demonstrate the valuelessness of the debts. *Riss v. Commissioner*, 478 F.2d 1160 (8th Cir. 1973); *Crown v. Commissioner*, 77 T.C. 582, 598 (1981); *Hubble v. Commissioner*, 42 T.C.M. 1537, 1544 (1981). *Estate of Mann*, 731 F.2d 267, 276 (5th Cir. 1984). However, when or whether a debt becomes worthless is a question of fact, the answer to which lies in an examination of all the circumstances. *Boehm v. Commissioner*, 326 U.S. 287, 293 (1945); *Estate of Mann*, 731 F.2d 267, 275 (5th Cir. 1984); *Dallmeyer v. Commissioner, supra* at 1291. When a debt becomes worthless is to be decided by the trier of fact. *Cole v. Commissioner*, 871 F.2d 64, 66 (7th Cir. 1989), *aff'g.* T.C. Memo. 1987-228. A bad debt is deductible only in the year it becomes worthless. *Denver & Rio Grande Western Railroad Co. v. Commissioner*, 32 T.C. 43, 56 (1959), *aff'd.* 279 F.2d 368 (10th Cir. 1960); *Feinstein v. Commissioner*, 24 T.C. 656, 658 (1955). Worthlessness is determined by objective standards. *Perry v. Commissioner*, 22 T.C. 968, 973 (1954). Some factors that have been considered by courts in determining worthlessness include the subordinated status of the debt (*Cole v. Commissioner, supra* at 67); a decline in the debtor's business (*Continental Illinois National Bank & Trust Co. of Chicago v. United States*, 81-1 USTC par. 9185 (N.D. Ill. 1981)); the decline in value of the property secured by the debt (*Meurer Steel Barrel Co., Inc. v. Commissioner*, 7 B.T.A. 64, 66 (1927)); claims of prior creditors far in excess of the fair market value of all assets available for payment (*Hadley Falls Trust Co. v. United States*, 110 F.2d 887, 890-891 (1st Cir. 1940)); the overall business climate, the debtor's earning capacity, the debtor's serious financial reverses, guarantees on the

debt, events of default, whether major or minor, insolvency of the debtor, the obligor's refusal to pay, abandonment of assets or business, ill health, death, or disappearance of the principals, bankruptcy or receivership, actions of the obligee in pursuing collection, i.e., whether the obligee unreasonably failed to take collection action and then claimed the deduction, subsequent dealings between the obligee and obligor, and lack of assets (*Cole v. Commissioner, supra*).

No single factor is conclusive as there are no absolutes in this area. *See* 2 B. Bittker & L. Lokken, *Federal Taxation of Income, Estates and Gifts*, sec. 33.3.1, pp. 33-10 to 33-11 (2d ed. 1990). Default is a factor considered in deciding whether an obligation is worthless. *Cole v. Commissioner, supra*. However, the fact that a debt had not matured does not prevent a finding of worthlessness. *Bonynge v. Helvering*, 117 F.2d 157, 158 (2d Cir. 1941), *aff'g.* 41 B.T.A. 84 (1940); *Robert Smith Corp. v. Commissioner*, 21 B.T.A. 1400, 1405 (1931). Similarly, the fact that a bad debt is not due at the time of deduction does not of itself prevent its allowance under section 166. Sec. 1.166-1(c)(7), Income Tax Regs. A taxpayer need not wait for a default before taking a bad debt deduction if the debt is clearly worthless before any payments are due. *Bonynge v. Helvering, supra* at 158.

Legal action is not required before a bad debt deduction is allowable where the surrounding circumstances indicate that a debt is worthless and uncollectible and that legal action to enforce payment would in all probability not result in the satisfaction of execution on a judgment. However, a showing of these facts will be sufficient evidence of the worthlessness of the debt for

purposes of the deduction under section 166. Sec. 1.166-2(a) and (b), Income Tax Regs.; *Exxon Corp. v. United States*, 785 F.2d 277, 279 (Fed. Cir. 1986). In determining worthlessness, no one factor is controlling.

It is obvious that there is no precise test for determining worthlessness within the taxable year and neither the statutory enactment, its regulations, nor the decisions attempt such an all-inclusive definition. Furthermore, it is often impossible to select a single factor or "identifiable event" which clearly establishes the time at which a debt becomes worthless and thus deductible. *Minneapolis, St. Paul Railroad Co. v. United States*, 164 Ct. Cl. 226, 240 (1964). All pertinent evidence should be considered. Sec. 1.166-2(a), Income Tax Regs. See also *Estate of Mann*, 731 F.2d 267, 276-277 (5th Cir. 1984):

> Subsequent events may only be used to evaluate the soundness of the belief that a debt became worthless in a certain year, and not as evidence of the fact of worthlessness. . . . The fact that a debt reasonably determined to be worthless in a given taxable year, is subsequently recovered in part or in full, is not in itself sufficient to prevent the deduction. . . .
>
> If and when such a debt becomes wholly worthless must be determined from the facts and circumstances known or which *reasonably could have been known at the end of the year of asserted worthlessness*. . . . Of course, proof of subsequent events may be allowed, as they were here, insofar as they may be relevant to the reasonableness of a conclusion that a debt became worthless in the particular year. . . .

Id. at 278 and n. 19. (Emphasis added)

In this case we have percipient witnesses' testimony. Also subsequent events, such as the demonstrable worthlessness of Cheng's bankruptcy estate, can be taken into account under *Mann* to assess the reasonableness of a determination of worthlessness in 1988 and 1989.

The findings of the bankruptcy court are not only not clearly erroneous, but are clearly supported by uncontroverted evidence. The conclusions are appropriate under the law.

Since the FTB never made an assessment of the tax in question, is there any presumption of validity under state law?

The FTB notice of proposed assessments were issued on April 3, 1992, almost two years after the Debtor commenced his bankruptcy case in 1990, at a time when the FTB knew that the IRS audit report was being contested in the bankruptcy court. Supp. ER6 and DCR4 at 576-577, 595-596, 612-613 (attachment to FTB pleading). The FTB did not, and because of the automatic stay under 11 U.S.C. § 362, could not, assess the tax in question. Accordingly there is no assessment by the FTB to which presumptive validity can attach. Although most of the FTB's brief is dedicated to arguments why state law relating to burden of proof should govern in this case, the FTB's brief never tells this Court what state law governs. At page 12 of its brief the FTB cites two decisions holding that in refund claim litigation in state court the taxpayer has the burden of proving the right to repayment of a tax the taxpayer has paid. *Nowhere does the FTB tell this Court what state law imposes upon the taxpayer the burden of proving the lack of validity of an unassessed state tax based on an*

abandoned IRS report. This Court may hold that the FTB has waived its argument on this issue.

Is a FTB proposed assessment based on an IRS audit report which was abandoned by the U.S. Department of Justice entitled to presumptive validity?

The FTB's attempt to make this a test case to establish in this circuit whether or not the procedural bankruptcy claims allowance rules applicable by their terms to everyone apply to tax collectors fails if the claim of the FTB is not entitled to presumptive validity. As noted above all that the FTB did was adopt an IRS audit report which was being contested in bankruptcy court and which was later replaced by a stipulation in bankruptcy court settling the IRS claim essentially for the costs of litigation. Even after the audit report had been abandoned by the U.S. Department of Justice the FTB continued to rely on it for its proof of claim. The FTB admitted that it conducted no audit or investigation or made any inquiry beyond the IRS audit report. Supp. ER6 and DCR4 at 576-577. On these facts the presumptive validity of the FTB's claim would be subject to doubt in any court. In *Portillo v. C.I.R.*, 932 F.2d 1128 (5th Cir. 1991) the court held that the IRS' assessment based on an information return filed by a person who paid the taxpayer money was not a "determination" and the assessment was not entitled to presumptive validity. The FTB relied on information received from another person without making any independent determination as did the IRS in *Portillo* and the result should be the same; the FTB claim should have no presumptive validity. This is particularly true on the facts of this case which include the repudiation of the information upon which the FTB relied.

Should the determination of the validity of the claim of a tax claimant be conducted differently from the determination of the validity of the claim of any other claimant in the absence of any bankruptcy law or rule giving it special treatment?

If this Court concludes, as Debtor contends, that even if he had the burden of proving his entitlement to the deductions, he has carried it, then most of the FTB's brief is not material to the issues which have to be resolved in this appeal.

It is apparent that the FTB, and other commentators, have not analyzed all of the possible consequences of the contention that the allocation of burden of proof outside of bankruptcy court should govern allocation of burden of proof in bankruptcy court. For example, outside of bankruptcy court the government must prove civil fraud by clear and convincing evidence. *Ackland v. C.I.R.*, 767 F.2d 618 (9th Cir. 1985). But in bankruptcy court the government must prove civil fraud only by a preponderance of evidence. *Grogan v. Garner,* 111 S.Ct. 654 (1991). It is clear that federal objectives modify for bankruptcy purposes burden of proof rules otherwise applicable. Regarding fraud, the modification is to the government's benefit; regarding competing with other creditors for a debtor's assets in the claims allowance process, the modification creates a level playing field. The tax claimant, as well as all other claimants, should have to prove entitlement to priority and amount by a preponderance of the evidence.

The Court should be aware that all courts who have addressed the issue agree that a tax claim arising during a bankruptcy case is not entitled to any presumptive

validity. *In re Fullmer*, 962 F.2d 1463, 1467 (10th Cir. 1992); *In re Glen Eden Hosp., Inc.*, 172 B.R. 538 (Bk. E.D. Mich. 1994); *In re Allen Care Centers, Inc.*, 163 B.R. 180 (Bk. D. Or. 1994). In these cases the courts held that absent the application of F.R.B.P. 3001(f), tax claimants are not entitled to the burden of proof allocation applicable outside of bankruptcy court. If the FTB's argument is correct, then these decisions are wrong.

The Fifth Circuit in *In re Placid Oil Co.*, 988 F.2d 554 (5th Cir. 1993) held that tax claims were to be determined just like any other claim insofar as burden of proof was concerned. While tax claims are granted priority when allowed, the bankruptcy code does not specify any special advantage which tax authorities have in the claims allowance process. *Accord, California State Board of Equalization v. Official Unsecured Creditors Comm. (In re Fidelity Holding Co., Ltd.)*, 837 F.2d 696 (5th Cir. 1988).

In addition to the absence of any express statutory advantage, it has been argued, and it is true, that it is not the taxpayer and the tax collector who are at issue in a tax claim contest in bankruptcy court, but rather the estate and the tax collector. It happens that in this case the Debtor is the representative of the estate. As provided by 11 U.S.C. § 1107(a) he acts as trustee for the estate. If the estate were represented by a trustee, as happens in every Chapter 7 case and many Chapter 11 cases, who was not the Debtor most of the arguments made by the FTB relating to access to information here would be groundless. *The bankruptcy code does not allocate burdens of proof dependent on whether one person or the other is trustee of an estate.* The primary authority relied on by the FTB indeed did involve a trustee who was not the debtor. *Internal*

Revenue Service v. Levy (In re Landbank Equity Corporation), 973 F.2d 265 (4th Cir. 1992). In that case neither the tax collector nor the trustee had access to the relevant factual evidence. This distinction with a difference exists even in refund claim litigation in federal district courts in which substantive law is disregarded in some contexts because the parties before the court are different from the parties between whom the law regulates substantive relations.

It is apparent that *Levy* overstated the authorities upon which it relied and that its holding regarding burden of proof is a dictum. In that case the claim was prima facie valid, as it is here, and the trustee offered no evidence in opposition. No new law needed to be pronounced by the Fourth Circuit to hold for the tax collector. Furthermore, the references to legislative history and interpretations of the court in *Levy* were simply wrong. The erroneous statements of the court in *Levy* simply do not detract from the result required by the difference in parties before the court and outside the court, the language of the bankruptcy code which states that there shall be a priority for certain claims when they are allowed but specifies no advantage for the tax collector in the allowance process, the interpretation of United States Supreme Court decisions relating to claims allowance and determinations in the bankruptcy court summarized and analyzed hereafter, and two decisions of the Fifth Circuit which do expressly address this issue one of which involves a California state tax collector. It is well established that although state law determines property rights, federal bankruptcy law determines both the manner and the time in which such rights are to be determined and the federal consequences to be attached

to such property rights. The FTB's argument first that the burden of proof under state law in state courts is akin to a property right and second that it is governing in determining whether another creditor of a bankruptcy estate gets less simply because a tax claim rather than a nontax claim of the same amount is asserted doesn't seem to be consistent with the federal bankruptcy policy reflected in the statutes and Supreme Court decisions which bear on this subject. The FTB's ubiquitous citations to *Vanston Bondholders Protective Comm. v. Green,* 329 U.S. 156, 67 S. Ct. 237 (1946) in support of its position fail to quote the most relevant passage from the opinion: "In determining what claims are allowable and how a debtor's assets shall be distributed, a bankruptcy court does not apply the law of the state where it sits." *Id.* at 329 U.S. 162. It should also be noted that in addition to the substantive decisions regarding the paramount nature of federal law in bankruptcy cases, a strong argument can be made that the FTB in filing its claim consented to a federal burden of proof rule. *See also,* E. Martin, *Consent: The Constitutional Basis for Bankruptcy Judge Authority,* 19 Cal. Bankr. J. 1 (1991).

Debtor contends that the FTB must bear the ultimate burden. *In re Federated Department Stores, Inc.,* 135 B.R. 950, 957-58 (Bk. S.D. Ohio 1992): "This Court finds that the better reasoned cases are those that treat the government as any other creditor in bankruptcy, and accordingly, place the burden on the IRS to establish its claim. . . . These decisions hold that the government must be treated like any other claimant in bankruptcy court and is not entitled to any special exception." *See also In re Premo,* 116 B.R. 515 (Bk. E.D. Mich. 1990); *In re Compass*

Marine Corp., 146 B.R. 138 (Bk. E.D. Pa. 1992); *In re Rasbury*, 130 B.R. 990 (Bk. N.D. Ala. 1991), *aff'd* 141 B.R. 752 (N.D. Ala. 1992); *In re Dakota Industries*, 131 B.R. 437 (Bk. S.D. 1991) ("The Court concludes that 11 U.S.C. § 502(a)'s allocation of the burden of proof applies in tax assessments."); *In re Imperial Corporation of America*, 91-2 USTC ¶ 50,342, [1990-1991 Transfer Binder] Bankr. L. Rep. (CCH) ¶ 74,096 at 99,759 (Bk. S.D. Cal.).

In a claims contest it is the objection which is heard, not the claim, *Controller of California v. Lockwood*, 193 F.2d 169, 171 (9th Cir. 1952) citing *Whitney v. Dresser*, 26 S. Ct. 316, 317 (1905), yet the burden of persuasion is on the claimant. Furthermore, the Debtor may file a claim and object to it. *Kilen v. United States (In re Kilen)*, 129 B.R. 538 (Bk. N.D. Ill. 1991).

In *Internal Revenue Service v. Levy (In re Landbank Equity Corporation)*, 973 F.2d 265 (4th Cir. 1992), the issue was whether the trustee of a Chapter 7 estate had the burden of proving that the estate was entitled to a bad debt deduction from income of the estate. The issue arose in the context of a claim by the IRS for prepetition taxes which was first agreed to by the trustee but which he later sought to have disallowed. The factual issue involved was the year in which debts became worthless. It was impossible for either the trustee or the IRS to show in which years the debts became worthless; accordingly the issue of who had the burden of proving the timing of the worthlessness was determinative of the controversy.

The court in *Levy* in very broad terms held that the burden of proof rules which would have applied in a

nonbankruptcy forum, should also apply in the bankruptcy forum and there existed no equitable reason why the nonbankruptcy forum rule should not be applied.

The Debtor here argues that the result in *Levy* was arguably correct because the IRS' claim was entitled to prima facie validity under F.R.B.P. Rule 3001(f) and there was no evidence to rebut the prima facie validity of the claim. However, the additional reasons for its decision stated by the court were dicta, and the court clearly failed to accurately apply governing precedents and erroneously characterized the historical treatment of tax claims in bankruptcy, since the 1938 Chandler Act first obligated tax authorities to file claims in bankruptcy cases. The burden of proof rule is in any event a rule which by its terms applies only in a controversy between a taxpayer and a taxing agency and in this case and in every bankruptcy case the controversy is between the taxing agency and other creditors of the Debtor. The equitable objective of equality in treatment in bankruptcy distributions requires that the taxing agencies and other creditors compete on an equal footing governed by only the rules in bankruptcy cases and not by presumptions and burdens of proof which apply in controversies which are not in a bankruptcy context.

The customary IRS burden of proof argument outside of a bankruptcy case is set forth in *United States v. Molitor*, 337 F.2d 917, 922-923 (9th Cir. 1964):

> When, therefore, an assessment has been made by this officer it is to be presumed until such presumption is overcome by proof to the contrary that it was made upon sufficient evidence. . . . Such an assessment is not, however,

> conclusive evidence of the liability of the distiller; it is open to attack; it is prima facie proof only of such liability, and prima facie evidence is such evidence as is sufficient, when unassailed, to establish a given fact, and it remains sufficient for that purpose until it is rebutted and overcome.
>
> And upon it being so made to appear, the burden of proof then shifts to the plaintiffs [the IRS], and it then becomes incumbent on the plaintiffs to maintain and establish the correctness of the assessment. . . .

This prima facie validity standard is not different from the bankruptcy standard under F.R.B.P. Rule 3001(f) which the court could have chosen to apply in *Levy* rather than expound as it did on issues which were not germane to the decision. In *United States v. Sampsell*, 224 F.2d 721, 722-23 (9th Cir. 1955), the Ninth Circuit disposed of a controversy similar to that in *Levy* by simply saying: "[A] sworn proof of a tax claim in proper form establishes a prima facie case for the allowance of the claim. The burden of proof is on the claimant, but the burden of going forward and introducing evidence to rebut the prima facie case is on the objecting party. The trustee has not met this burden."

It should also be noted that procedural burden of persuasion differs somewhat in each of the three federal courts with jurisdiction in tax matters. If a uniform burden of persuasion standard is to be adopted, which is more appropriate than another? To paraphrase *Cheng v. Gill (In re Cheng)*, 943 F.2d 1114, 1117 (9th Cir. 1991), the rule applied should be one which is most apparent and in this case it is the standard simply of F.R.B.P. 3001(f).

Accordingly, it appears that if the *Levy* court had limited its holding to the holding dispositive of the case, the same result would have obtained from merely the application of F.R.B.P. 3001(f) without the verbal embroidery to which most of the opinion is devoted and since F.R.B.P. 3001(f) most specifically applies to this issue, it should govern.

The opinion in *Levy* states that substantive law applies in determining the validity of claims against a bankruptcy estate. Again, the Debtor in the case at bar agrees with the rule but not how it has been applied. *Levy* cites *Dick v. New York Life Ins. Co.*, 359 U.S. 437, 446 (1959) as holding that burden of proof rules are "substantive" and that therefore they are applicable in tax determinations in bankruptcy court. *Dick* was an accidental death diversity jurisdiction case, not a federal jurisdiction case in which substantive law, state or federal, was sought to be applied. *Dick* merely held at the cited page that "[u]nder the *Erie* rule, presumptions (and their effects) and burden of proof are 'substantive' and hence respondent was required to shoulder the burden during the instant trial."

Perhaps a more appropriate starting point for the analysis of the applicability of the "outside of bankruptcy court" burden of proof rule in bankruptcy court would have been *Grogan v. Garner*, 111 S.Ct. 654, 657-658&n.9 (1991) in which the court said:

> At the outset, we distinguish between the standard of proof that a creditor must satisfy in order to establish a valid claim against a bankruptcy estate and the standard that a creditor who has established a valid claim must still

> satisfy in order to avoid dischargeability. The validity of a creditor's claim is determined by rules of state law. See *Vanston Bondholders Protective Comm. v. Green*, 329 U.S. 156, 161, 67 S.Ct. 237, 239, 91 L.Ed. 162 (1946). Since 1970, however, the issue of nondischargeability has been a matter of federal law governed by the terms of the Bankruptcy Code. . . .

In *Vanston*, cited in *Grogan* as announcing the ultimate rule governing the issue in the case at bar, the Court did what the *Levy* court said it was not empowered to do: it denied the allowance of a claim without regard to state law because state law could not contravene the overriding bankruptcy objective of equality and equity in distribution.

> A purpose of bankruptcy is so to administer an estate as to bring about a ratable distribution of assets among the bankrupt's creditors. What claims of creditors are valid and subsisting obligations against the bankruptcy at the time a petition in bankruptcy is filed, is a question which, in the absence of overruling federal law, is to be determined by reference to state law. . . . [A]ssuming, arguendo, that the obligation for interest on interest is valid under the law of New York, Kentucky, and the other states having some interest in the indenture transaction, we would still have to decide whether allowance of the claim would be compatible with the policy of the Bankruptcy Act. . . . *In determining what claims are allowable and how a debtor's assets shall be distributed, a bankruptcy court does not apply the law of the state where it sits.* . . . Bankruptcy courts must administer and enforce the Bankruptcy Act as interpreted by

> this Court in accordance with authority granted by Congress to determine who and what claims shall be allowed under equitable principles. . . . It is manifest that the touchstone of each decision on allowance of interest in bankruptcy, receivership and reorganization has been a *balance of equities between creditor and creditor* or between creditors and the debtor. . . . (emphasis added)

Id. at 67 S. Ct. 239-241 and note 5. Ironically, the Fourth Circuit held that "*Vanston's* vitality has not diminished," *In re Twin Parks Ltd. Partnership*, 720 F.2d 1374, 1377 (4th Cir. 1983), and it applied the preemption standard of *Vanston* to define a "claim" in *Grady v. A.H. Robins Co., Inc.*, 839 F.2d 198, 201-202 (4th Cir. 1988), again to do what it said in *Levy* it could not do. And an examination of the decisions relied on in *Vanston* indicates that *Vanston* was not the first decision to determine the allowability of a claim by reference to the equitable objectives of the bankruptcy laws. Judge Ryan in *In re DWS Investments, Inc.*, 121 B.R. 845 (Bk. C.D. Cal. 1990) likewise applied *Vanston* to achieve a equitable distribution and in *Southwest Bank v. Parsons (In re Parsons)*, 124 B.R. 818 (Bk. S.D. Cal. 1991) the court cited both *Grogan* and *Vanston* in deciding the issue before the court. The Ninth Circuit in *Official Cattle Contract Holders Committee v. Commons (In re Tedlock Cattle Company, Inc.)*, 552 F.2d 1351, 1352-1353 (9th Cir. 1977) did likewise in declining to follow California law in allowing a claim applying instead equitable bankruptcy principles and in *United States v. Robinson (In re D.C. Sullivan & Co., Inc.)*, 929 F.2d 1, 6 (1st Cir. 1991) the court noted that the *Ron Pair* decision adopted the *Vanston* approach.

Accordingly it is apparent that although state substantive law must be applied to determine the "substantive rights" of the claimant, it is not so apparent whether the burden of persuasion rule should be applied if it causes a deviation from the objective that all claimants should be treated alike. *Levy* asserts that because government claimants have always been given the burden of proof in bankruptcy cases which they would have had outside of the bankruptcy case, Congress did not intend to change such application. However, the authority cited by *Levy* for the proposition that governments have been given the benefit of more than a prima facie validity of their claims consists of decisions in which the issue wasn't raised, *Resyn Corp. v. United States*, 851 F.2d, 660, 662-63 (3rd Cir. 1988); *United States v. Uneco, Inc. (In re Uneco, Inc.)*, 532 F.2d 1204, 1207 (8th Cir. 1976), followed by a "but see" signal to *California State Bd. of Equalization v. Official Unsecured Creditors Comm. (In re Fidelity Holding Co., Ltd.)*, 837 F.2d 696, 698 (5th Cir. 1988) in which the issue was raised and in which it was held that a California taxing agency should be treated just like any other claimant without the benefit of any special advantage available to it under state law. Consequently one must look elsewhere to ascertain what the historical treatment of tax claims has been in bankruptcy cases to ascertain what it was that Congress did or did not intend to change.

The standard treatise on the Bankruptcy Act, 3A J. Moore, *Collier on Bankruptcy* ¶ 64,409 at 2244 (14th ed. 1988) states: "As in the case of other types of claims, a filed proof of a tax claim in proper form establishes a prima facie case for the allowance of the claim. The

burden of proof is on the claimant, but the burden of going forward and introducing evidence to rebut the prima facie case is on the objecting party. In *Nicholas v. United States*, 86 S. Ct. 1674, 1679 n.4 (1966) the Court notes that "in 1938, however, Congress amended the Bankruptcy Act by reducing tax debts to the status of a fourth priority . . . and by requiring tax claims to be proved in the bankruptcy proceeding like ordinary debts . . . In *Saper*, the Court held that, in light of these amendments, tax debts had become sufficiently clothed with the characteristics of other bankruptcy debts to justify the application of the general rule. . . . "

Similarly see *Heiser v. Woodruff*, supra, 66 S. Ct. at 860 n.1 (1946) which was relied on by *Vanston* and *Note, Taxation During Bankruptcy Liquidation*, 55 Harv. L. Rev. 1141, 1146 (1942).

There is very little to indicate that tax claims were given the benefit historically of more than the prima facie validity accorded to all claims when the issue was relevant. As noted in *United States v. Sampsell*, 224 F.2d 721 (9th Cir. 1955), it appeared that the court assumed the customary bankruptcy standard applied. In *Dickinson v. Riley*, 86 F.2d 385 (8th Cir. 1936) the court expressly held that presumptive validity under state law would not govern the allowability of a tax claim in a bankruptcy case. *New Jersey v. Anderson*, 27 S. Ct. 137, 140 (1906) held that state law characterization of a state exaction as a tax was not governing for purposes of classifying the exaction as a tax entitled to priority. In *Industrial Commission of Ohio v. Highway Const. Co. of Ohio*, 105 F.2d 863, 866 (6th Cir. 1939), the state argued that its state statute should govern the prima facie validity of its claim. The court rejected

that position and stated that the customary bankruptcy standard applied to determine the validity of the claim. Likewise in *In re Hotel Martin Co. of Utica*, 41 F. Supp. 392 (N.D.N.Y. 1941) the court dealt with a claim for taxes as if only the bankruptcy procedures for claim allowance governed and restrained recourse to any state procedures for determination of the claim. These authorities are considerably more persuasive than the authorities cited by *Levy* except for the "but see" reference in *Levy* to the Fifth Circuit decision which holds against *Levy* and which *Levy* attempted to distinguish in passing **by implying that it only applied to state taxes.** *California State Bd. of Equalization v. Official Unsecured Creditors Comm. (In re Fidelity Holding Co., Ltd.)*, 837 F.2d 696, 698 (5th Cir. 1988).

There are three commentaries contemporaneous with the period after the 1938 adoption of the Federal Rules of Civil Procedure and the changes to the Bankruptcy Act and the *Erie* decision when the consequences of these three events were being hotly debated: Hill, *The Erie Doctrine in Bankruptcy*, 66 Harv. L. Rev. 1013 (1953) (herein "Hill – Erie"); Hill, *State Procedural Law in Federal Nondiversity Litigation*, 69 Harv. L. Rev. 66 (1955) (herein *"Hill – State"*); and Note, *Tax Claims in Bankruptcy*, 29 Virginia L. Rev. 206 (1942). *Hill – Erie*'s reference to the *Vanston* rationale at page 1017 and at pages 1038 and 1039 states:

> "The theme of the Bankruptcy Act," the Supreme Court has said, "is equality of distribution." But this theme is only barely suggested by the express terms of the Act. The Act does not, as it cannot, say what constitutes equality of distribution; the determination is left to the

> bankruptcy court, as a "court of equity," on a case to case basis. But, in the light of what has been said earlier, the equity power of the bankruptcy court is essentially the power to carry out bankruptcy objectives. . . . It would therefore seem to be a safe working hypothesis that, in pursuance of the bankruptcy objective of equality of distribution, the bankruptcy court is free to apply overriding federal law in determining the consequences of acts of a claimant which created equities in other claimants of a character having relevance only in the context of distribution in insolvency.

Hill – State is a lengthy analysis of the general subject matter involved here and at pages 67, 69, 74, 90, 92 and 97 to 98 has much to say about the general consideration of the issue at bar noting in general that

> in cases where effect is given to state-created substantive rights the courts should be alert to the possible existence of overriding federal policies adopted by Congress in pursuance of a valid legislative object. Thus, however important presumptions may be in the devolution of title to property under state law, the federal tax scheme may shift the burden of proof, for tax purposes, to the taxpayer. And in pursuance of valid bankruptcy objectives Congress may establish presumptions without regard to the presumptions which may arise from the transactions under state law.

As noted in *Vanston*, the court is required to strike an equitable balance between "creditors and creditors" in the distribution process. The district court in the *Levy* case thought that all creditors should be on an equal footing and that the presumption which applied between

a taxpayer and the IRS should not apply between one creditor and another creditor. *In Re Levy*, 130 B.R. 28 (E.D. Va. 1991). Perhaps the validity of that observation is apparent from the analysis of an analogous issue – the applicability to a bankruptcy contested matter of state parole evidence rules and statutes of fraud when the contested matter involves a trustee and the IRS or a state taxing agency.

The parole evidence rule and statutes of frauds are not rules of evidence, rather they are rules of substantive law founded upon the substantive rights of the parties similar for this purpose to burden of proof rules. *Vickery v. Fisher Governor Co.*, 417 F.2d 466, 468 (9th Cir. 1969).

When the parole evidence rule or a statute of frauds is at issue in a bankruptcy proceeding, the bankruptcy court generally must apply the law of the state in which it sits to resolve the issue. *In re Beverly Hills Bancorp*, 649 F.2d 1329, 1334-1335 (9th Cir. 1981); *In re California Pump & Mfg. Co., Inc.*, 588 F.2d 717 (9th Cir. 1978).

Notwithstanding the rule regarding applicability of substantive law, however, it is clear that in a contested matter in bankruptcy court between a trustee and the IRS, the IRS could not assert the rule or the statute as a bar to the admission of evidence. In *Mustard v. U.S.*, 155 F. Supp. 325 (Ct. Cl. 1957) the taxpayer transferred an interest in a promissory note to a charitable beneficiary under a written assignment transferring absolute ownership on the face of the instrument of transfer as compensation for services rendered by the transferee. The IRS disallowed the deduction on the grounds that the transfer was for

services rendered by the trustee as specified in the instrument of transfer. The taxpayer contended that the transfer was subject to an oral trust under which the transferee was to hold the property transferred in trust and apply the payments on the note to purposes specified in the terms of the oral agreement. The taxpayer was allowed to prove the existence of an oral trust contrary to the terms of a written instrument unambiguous on its face because the IRS is not a party who can raise either the parole evidence rule or the statute of frauds as a defense in a tax controversy because it was not a party to the transaction at issue. *Id.* at 332-33.

In keeping with the rationale that a bankruptcy proceeding is a division of a res in the custody of the court and that claimants consent to the rules and authority of the court when they file a claim, Martin, *Consent: The Constitutional Basis for Bankruptcy Judge Authority*, 19 Cal. Bk. J. 1 (1991), it does not seem too far fetched to conclude that rules which may apply when contestants are the taxpayer vs. the government need not apply when the contestants are somebody else. As noted in Hunt, *Tax Claims in Bankruptcy Proceedings*, 14 J. of the National Assoc. of Referees in Bankruptcy 3, 5 & 8 (1939) (cataloged in libraries as the first volumes of the current American Bankruptcy Law Journal):

> It seems to me that when bankruptcy intervenes a new element enters upon the scene, viz., the creditors. . . . Once bankruptcy intervenes, however, the creditors are put in the saddle through their trustee. . . . [I]t is settled that the power of the state officials. . . . to determine and levy taxes must yield to the constitutional power of the federal government to establish what it

> reads as just rules for liquidation in bankruptcy. . . . The bankruptcy act was drafted with the principle that "equality is equity" in mind, but there has been a tendency in recent years for the typical bankruptcy proceeding to resolve itself into a process in which one preferred party after another slices off a portion of the available assets with little or no remaining for distribution to general creditors. This process ought not to be extended beyond the clear requirements and control of the statutes.

It is useful to ascertain from other decisions whether there are any clues to how this issue will be decided by the Supreme Court. Certainly the court has followed a policy of treating the government claimant the same as any other claimant. Thus in *United States v. Ron Pair Enterprises, Inc.*, 109 S.Ct. 1026 (1989), this equality of treatment was to the benefit of the government while in *United States v. Whiting Pools, Inc.*, 103 S. Ct. 2309 (1983) this equality was to the government's detriment. ("We see no reason why a different result should obtain when the IRS is the creditor." *Id.* at 2315.). More recently the decision in *Patterson v. Shumate*, 112 S. Ct. 2242 (1992) was presaged by the Court's decision in *Guidry v. Sheet Metal Workers Nat. Pension Fund*, 110 S:Ct. 680 (1990) in which the Court stated "[u]nderstandably, there may be a natural distaste for the result we reach here. The statute, however, is clear. In addition, as has been noted above, the malefactor often is not the only beneficiary of the pension", *id.* at 688, thus indicating, with important implications here, that one must look to the real parties in interest in a bankruptcy case to determine issues. *Patterson* also emphasized the desirability of uniform treatment

of pension plans unaffected by state law variations. There is an indication in 11 U.S.C. § 346, 728 and 1146 that the same uniformity in state tax claims was intended by Congress.

As noted, the real parties are the creditors and the equitable objectives of the Bankruptcy Code would be best served by adopting what *Grogan* referred to as "a roughly equal allocation of the risk of error between litigants . . . " *Grogan v. Garner,* 111 S. Ct. 654, 659 (1991). As *Grogan* also noted, adoption of this standard would simplify determination of claims because it is well established that the tax claimant has the burden of persuasion as to priority and dischargeability. "Requiring the creditor to establish by a preponderance of the evidence that his claim is not dischargeable reflects a fair balance between these conflicting interests." *Id.*

The only other authorities cited by *Levy* not replied to above are the quotes from the 1973 Report of the Commission on the Bankruptcy Laws of the United States, H.R. Doc. No. 137, which can be found in Volume 2 of the Appendix to L. King, *Collier on Bankruptcy* (15th ed. 1993). *Levy* states the report recognizes "the need to create a bankruptcy system which obviates criticism based on the ground which involves the different results likely to be obtained in bankruptcy courts and nonbankruptcy courts" 973 F.2d 265, 270 (4th Cir. 1992). The context of the report from which this quotation was taken dealt with the desirability of having bankruptcy judges removed from administration of cases so that they could be more impartial in adversary proceedings and hardly is relevant to the issue in *Levy*. The same report, however, in the

more germane portion of it which deals with "Determination of Tax Liability by the Bankruptcy Courts" states that: "[t]he customary procedures of litigation of tax liabilities, through the Tax Court or by suit for refund, have in large part been abrogated in cases of bankruptcy . . . Ever since the Chandler Act of 1938, it has been required that the government file its claim for *pre-bankruptcy* taxes, whether previously assessed or not, within the same period required of other creditors . . . " H.R. Doc. No. 137 at 292-293. Perhaps more importantly, the Report cites to *Bailey v. Glover*, 88 U.S. (21 Wall) 342, 346 (1875) which stated: "It is obviously one of the purposes of the Bankrupt Law, that there should be a speedy disposition of the bankrupt's assets. This is only second in importance to securing equality of distribution. The Act is filled with provisions for quick and summary disposal of questions arising in the progress of the case, without regard to usual modes of trial. . . . "

REQUEST FOR RELIEF

Debtor requests that the court affirm the district court's affirmance of the bankruptcy court's findings of fact on the grounds that they are not clearly erroneous, affirm the district court's affirmance of the bankruptcy court's conclusions of law as correct, and reverse the district court's reversal of the bankruptcy court's judgment.

STATEMENT OF RELATED CASES

Pursuant to Circuit Rule 28-2.6, counsel certifies that to the best of his knowledge there are no related cases pending at this time in this Court.

Dated: June 27, 1995

_____

Elmer Dean Martin III

_____

(3)

Supreme Court, U.S.
FILED
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No. 96-235

In The

Supreme Court of the United States

October Term, 1995

FRANCHISE TAX BOARD OF THE STATE OF CALIFORNIA,

Petitioner,

v.

STEPHEN B. MACFARLANE,

Respondent.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

BRIEF FOR THE STATES OF ARIZONA, CONNECTICUT, HAWAII, IDAHO, IOWA, MASSACHUSETTS, MICHIGAN, MINNESOTA, MONTANA, NEVADA, NEW HAMPSHIRE, NEW YORK, NORTH CAROLINA, NORTH DAKOTA, OHIO, OKLAHOMA, OREGON, SOUTH DAKOTA, TEXAS, UTAH, VERMONT, VIRGINIA, WISCONSIN AND NEW MEXICO AS *AMICI CURIAE* IN SUPPORT OF PETITIONER

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No. 96-235

In The

Supreme Court of the United States

October Term, 1995

FRANCHISE TAX BOARD
OF THE STATE OF CALIFORNIA
Petitioner

v.

STEPHEN B. MACFARLANE
Respondent

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE STATES OF NEW MEXICO, *et al.*, AS *AMICI CURIAE* IN SUPPORT OF PETITIONER

The *amici curiae* states, through their undersigned attorneys general, respectfully submit this brief in support of the Franchise Tax Board of the State of California's petition for certiorari.

INTEREST OF *AMICI CURIAE*

One of the primary law enforcement responsibilities of state government is ensuring that citizens comply with state tax laws. The *amici* states have a vital interest in this case because the decision below significantly, unfairly and erroneously hampers the enforcement of those laws.

At issue is whether a taxpayer who has the burden of proof under state law can switch the burden to the government by filing for bankruptcy. This is not a rare or unusual situation. The Administrative Office of the United States Courts is projecting over one million bankruptcy petition filings in the United States in 1996 for the first time ever. An enormous amount of tax revenues are affected by the bankruptcy courts.

On several occasions, this Court has noted that burden of proof is an issue of substantive law. It will often determine the prevailing party in a legal proceeding. In the tax context, especially where the sales revenue or income is established and the issue involves a deduction or exemption, the rule of requiring the taxpayer to bear the burden of proof is essential and promotes the policies of tax administration. The alternative of requiring the government to disprove a claimed deduction of the taxpayer would not only be impractical, it would seriously undermine the companion laws requiring taxpayers to keep adequate documentation. Moreover, the gross disadvantage of the government as to knowledge of the particulars of the taxpayer's financial affairs makes placing the burden of proof on the taxpayer necessary and eminently fair.

SUMMARY OF ARGUMENT

1. The court below determined that in a bankruptcy proceeding the taxing authority has the ultimate burden of proving its claim. The court acknowledged that "the bankruptcy code is silent" on this issue and that its decision was based solely upon "policy considerations." The Ninth Circuit's refusal to apply the state law burden of proof violates both federal statutory and common law and conflicts with this Court's decisions. *See* 28 U.S.C. § 1652 (state law provides the "rules of decision in civil actions" in which state law is decided in federal court); *Butner v. United States*, 440 U.S. 48 (1979)

(Unless Congress specifically states otherwise, the basic rule in bankruptcy is that state law determines the substantive rights of the parties). Moreover, the decision below directly contravenes congressional intent—the decision treats governmental tax claims less favorably than other claims, even though Congress grants priority to tax claims.

2. The opinion of the court below would seriously disrupt the administration of tax laws by placing on governmental entities an unfair burden that does not exist outside bankruptcy courts. Because the burden of proof is more beneficial to taxpayers in the Ninth Circuit's bankruptcy courts than in state court on tax matters, the bankruptcy courts in that circuit will often reach a different conclusion than the state courts on the ultimate issue of liability. Such result is directly contrary to the doctrine of comity and federalism with regard to state law determinations in federal courts. *See Erie Railroad Co. v. Tomkins*, 304 U.S. 64 (1938). Since the bankruptcy forum has been rendered more favorable for taxpayers in some circuits than the non-bankruptcy forum, the case below will engender forum shopping, funneling people with tax problems into the bankruptcy courts, and the potential for significant loss of government revenues.

ARGUMENT

Mr. Macfarlane filed bankruptcy in 1990. The bankruptcy court denied claims for income tax for years 1988 and 1989, which claims are both entitled to priority under Code § 507(a)(8)(A)(i) and are non-dischargeable under Code § 523(a)(1)(A). Although the Court below discussed balancing the equities between the Board and the other creditors, 83 F.3d at 1045, the dispute was solely between the State of California and Mr. Macfarlane who is the principal beneficiary of the court's ruling.

The basis of the litigation was whether Mr. Macfarlane's bad debt deduction should be disallowed. The expenditures which gave rise to the "debt" were millions of dollars of withdrawals from Mr. MacFarlane's account made pursuant to blanket powers of attorney by his accountant, Mr. Cheng. The California Franchise Tax Board had reason to suspect that the advances did not constitute bona fide debts, notwithstanding the existence of promissory notes. *See In re Uneco, Inc.*, 532 F.2d 1204 (8th Cir. 1976) (after first ruling that the trustee had the burden of proving a bad debt deduction in bankruptcy, the court noted that there was no bona fide debtor/creditor relationship notwithstanding that the advances were carried on the debtor's books as accounts receivable); *Republic Steel Corp. v. U.S.*, 159 F.Supp. 366 (Ct. Cl. 1958) (promissory notes "floating around" on books were not enough to establish bona fide debt). Alternatively, even if the "debt" was bona fide, it might not have become a bad debt until after Mr. Macfarlane's bankruptcy and thus not deductible in the pre-bankruptcy tax years,[1] which would cause any deduction to be properly taken only with regard to a tax year or tax liability that is not subject to the bankruptcy court's jurisdiction. Mr. Cheng filed bankruptcy the year following Mr. Macfarlane's bankruptcy filing. By filing bankruptcy, Mr. Cheng probably avoided any taxable income which would have otherwise arisen from the write-off of his alleged indebtedness. 26 U.S.C. § 108(a)(1)(A). Both Mr. Macfarlane and Mr. Cheng may be able to avoid any tax liability relating to the depleted monies. The factual context raises suspicions.

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[1] A nonbusiness bad debt is treated as a short-term capital loss, 26 U.S.C. §166(d), which, for an individual, can only be carried forward, not backward. 26 U.S.C. § 1212(b).

The purpose of the court's opinion was to address "which party has the ultimate burden of proof in bankruptcy proceedings when a state files a claim for taxes alleging that a debtor's bad debt deductions are invalid." 83 F.3d at 1042.

The Bankruptcy Code provides no "rules of decision" for how claims should be determined. In the most general terms possible, Congress has stated only that, "if such objection to a claim is made, the court, after notice and a hearing, shall determine the amount of such claim in lawful currency . . . ." Code § 502(b). Similarly, Code § 505(a)(1) permits the court to "determine the amount or legality of any tax . . . ." As the court below recognized, "[t]he bankruptcy code is silent on the allocation of the ultimate burden of proof in [tax cases]." Bankruptcy courts are units of the United States district courts. 28 U.S.C. § 151. The Rules of Evidence apply in the bankruptcy courts. Federal Rule of Evidence 101.

Under 28 U.S.C. § 1652, the state law provides the rules of decision in cases where state law is to be determined in federal court. As a general, and well recognized, matter of tax law the ultimate burden of persuasion is placed on the taxpayer. *See Stohr. v. New Mexico Bureau of Revenue*, 90 N.M. 43, 559 P.2d 420 (Ct. App. 1976).[2] Although the tax at issue in the

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[2] *See also, e.g.*, N.C. Gen Stat. § 105-164.26 (presumed that all receipts of wholesalers and retailers are subject to sales tax); *Ward v. Clayton Comm'r. of Revenue*, 5 N.C. App. 53, 60, 167 S.E. 2d 809 (1969) *aff'd* 172 S.E.2d 531 (taxpayer has the burden of proving deductions); N.J.S.A. §§ 54:32B-12(b)(all sales presumed taxable), 54A:9-9(e) (taxpayer has burden of proof with certain exceptions); Iowa Code § 421.60(6) (Code Supp. 1995) (taxpayer has the burden of proof); *Patterson v. Heitkamp*, 442 N.W.2d 219 (N.D. 1989) (taxpayer has burden of proof); *Appeal of Net Realty Holding Trust*, 128 N.H 795 (1986) (taxpayer has the burden of proof). The *amici* States are aware

instant case is an income tax, the law is generally the same with regard to other state revenue sources, such as sales, gross receipts and excise taxes. *See*, NMSA § 7-9-5 (receipts from engaging in business in New Mexico presumed taxable). Rule of Evidence 301 provides that the ultimate burden of persuasion "remains throughout the trial upon the party on whom it was originally cast." Rule 302 provides that the effect of any presumption arising under state law is to be determined by state law.

Acknowledging that other circuits had reached the "opposite conclusion," 83 F.3d at 1045, the court ruled that the taxing authority had the burden of proof, notwithstanding that non-bankruptcy law puts the burden of proving deductions on the taxpayer. Since there is a direct conflict between the Ninth Circuit and the Fourth, *In re Landbank Equity Corp.*, 973 F.2d 265 (4th Cir. 1992), there is a conflict of cases in the lower courts,[3] and the result would impair state tax collections and

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of no states which require the government to disprove deductions.

[3] The Ninth Circuit construed cases from other circuits and determined that a majority of circuits had concluded that the burden of proof in bankruptcy was with the taxing authority. 83 F.3d at 1045. The Fourth Circuit construed other circuit caselaw and concluded that a majority of the circuits had ruled that the burden of proof in tax cases in bankruptcy court rested with the party objecting to the proof of claim. *In re Landbank Equity Corp.*, 973 F.2d 265, 271 (4th Cir. 1992). The opinion below is also in direct conflict with an Eighth Circuit case involving a bad debt deduction. *In re Uneco*, 532 F.2d 1204, 1207 (8th Cir. 1976). Although a majority of bankruptcy courts are probably in agreement with the Ninth Circuit, *see In re Wilhelm*, 173 B.R. 398 (Bankr. E.D. Wis 1994), the view of the courts on appeal would appear to be mixed. *See In re Ford*, 194 B.R. 583 (S.D. Ohio 1995) (reversing a bankruptcy court which placed the burden of proof on the IRS, and attempting to harmonize the cases on the basis of whether an assessment

transform the bankruptcy courts into the preferred forum for state and federal taxpayers to obtain a favorable determination of tax disputes,[4] the Court should grant certiorari.

I. THE COURT SHOULD GRANT CERTIORARI BECAUSE THE DECISION BELOW CONFLICTS WITH THE UNDERLYING PRINCIPLES OF *BUTNER V. UNITED STATES*, 440 U.S. 48 (1979) AND 28 U.S.C. § 1652 AND WITH CONGRESS' GRANTING STATUTORY PRIORITY TO TAX CLAIMS

The decision below conflicts with the longstanding principle that non-bankruptcy law governs the rights of creditors. There is no uniform rule regarding burdens of proof in bankruptcy, either statutorily or as a matter of practice, nor should there be. The so-called uniform rule created by the court below would apply only in tax cases and is created by an acknowledged desire to dilute the statutory priority of taxes in the bankruptcy courts.

As this Court has noted time and time again, burdens of proof are part of the substantive law of the state. *E.g.*, *Dick v. New York Life Ins. Co.*, 359 U.S. 437 (1959); *Palmer v.*

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was issued prior to the bankruptcy petition's being filed). Because the petition for a writ of certiorari fully demonstrates the existence of a circuit court conflict, this brief will not further address that reason for granting the writ.

[4] There is nothing preventing a debtor from filing a bankruptcy petition for no other reason than to obtain a favorable forum to litigate a tax problem. Code § 1307 (b) provides the a Chapter 13 debtor the absolute, non-waiveable, right to dismiss a bankruptcy petition, which the debtor could do subsequent to litigating his tax dispute.

Hoffman, 318 U.S. 109 (1943); *Cities Service Oil Co. v. Dunlap*, 308 U.S. 208 (1939). Consistent with those cases, this Court has ruled that when a federal claim is tried in state court, the state court must apply the federal law burden of proof, noting it "was a part of the very substance of his claim and cannot be considered a mere incident of procedure." *Garrett v. Moore-McCormack Co.*, 317 U.S. 239, 248-49 (1942). *See also, Director, OWCP v. Greenwich Collieries*, 510 U.S. ___, 114 S.Ct. 2251, 2254 (1994).

A basic background principle in the bankruptcy courts was succinctly stated in *Butner v. United States*, 440 U.S. 48, 55 (1979): "Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding." The Court noted that the "basic rule" in bankruptcy proceedings "is that state law governs." *Id.* at 57. "What claims of creditors are valid and subsisting obligations against the bankrupt at the time a petition in bankruptcy is filed, is a question which, in the absence of overruling federal law, is to be determined by reference to state law." *Vanston Bondholders Protective Comm. v. Green, et. al.*, 329 U.S. 156, 161 (1947). *See generally*, Hill, "Erie Doctrine in Bankruptcy," 66 Harv. L. Rev. 1013 (1953) (cited with approval in *Butner*, 440 U.S. at 52 n.2).

Whether a liability exists is often determined by which party had the burden of establishing certain claims or defenses, which is why that burden is considered "a part of the very substance of [the] claim." *Garrett*, 440 U.S. at 55. Altering non-bankruptcy burdens of proof will often create situations where, as the case below exemplifies, a debtor can avoid even non-dischargeable liabilities altogether by shifting to the creditor the burden of proving issues which the debtor bore outside of

bankruptcy. Debtors like Mr. Macfarlane, therefore, receive "a windfall merely by reason of the happenstance of bankruptcy." *Lewis v. Manufacturers National Bank*, 364 U.S. 603, 609 (1961). As was concisely stated by one bankruptcy court: "To rule [in favor of the taxpayer] would permit a tax litigant to shift the burden of proof to the [taxing authority] by filing bankruptcy." *In re Cobb*, 135 B.R. 640, 641 (Bankr. D. Neb. 1992).

The foundation upon which the court's opinion below is built is a "broad rule that taxing authorities are to be treated the same as other claimants *and must therefore bear the ultimate burden of proving their claims in bankruptcy*." 83 F.3d at 1045 (emphasis added). The problem here is that there is no "broad rule" that all claimants "bear the ultimate burden of proving their claims in bankruptcy." In short, the foundation of the court's opinion is constructed on a sinkhole.[5] Although it is *generally* true that claimants--as creditors and therefore the functional equivalent of plaintiffs under non-bankruptcy law--usually bear the burden of proof in bankruptcy as they would outside of bankruptcy, in a variety of circumstances courts have had little difficulty ruling that where non-bankruptcy law places the burden of proof on the debtor, the debtor retains the burden of proof even in a claim objection proceeding. *In re Unioil*, 962 F.2d 988, 994 (10th Cir. 1992) (since party seeking to prove an accord and satisfaction has the burden of proof under Colorado law, the debtor had the burden of proving an accord and satisfaction in a claim objection proceeding); *In re Farris*,

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[5] The court below stated that the "logic of that rule is compelling to us, and accordingly, we hold that the taxing authority has the ultimate burden of proof in the bankruptcy forum." In the absence of such a "broad rule" that creditors "bear the ultimate burden of proving their claims in bankruptcy," the opinion loses all logic, becomes rhetorically un-glued, and falls apart.

194 B.R. 931 (Bankr. E.D. Pa. 1996) (debtor had the same burden of proving likely Truth in Lending Act violation under non-bankruptcy federal law as any other party raising this defense); *In re El Paso Refining, Inc.*, 192 B.R. 144 (Bankr. W.D. Tex. 1996) (in claim objection proceeding in which debtor was a guarantor of a debt, court adopted non-bankruptcy caselaw and ruled that the debtor had the burden of proving that the debt between the creditor and the primary obligor had been satisfied); *In re Brummer*, 147 B.R. 552 (Bankr. D. Mont. 1992) (debtor had burden of proving debt was usurious under Montana law); *In re Biglari Import Export, Inc.*, 130 B.R. 43 (Bankr. W.D. Tex. 1991) (in claim objection proceeding, where creditor had seized collateral prior to the petition being filed, debtor had the burden of proving that the creditor did not exercise reasonable care with regard to repossessed collateral since Texas law put burden of proving this issue on the debtor); *In re Wills*, 126 B.R. 489, 497 (Bankr. E.D. Va. 1991) (summary judgment entered for creditor in claim objection proceeding because debtor had the burden of proving by clear and convincing evidence under Virginia law that contractual debt could be avoided on grounds of incapacity of the debtor at the time of signing the contract); *In re Woehr*, 121 B.R. 743 (N.D. Tex. 1990) (debtor had burden of proving debt usurious under Texas law); *In re Hood*, 95 B.R. 696, 702 (Bankr. W.D Mo. 1989) (debtor had the burden under Missouri law of proving that contract was entered into under duress); *In re Borum*, 60 B.R. 516 (Bankr. E.D. Ark. 1986) (debtor had the burden of proving usury under Arkansas law). The above decisions were not wrongly decided, nor were the cases with which the court below disagreed.

The real driving force of the opinion below, as well as the opinions upon which it relies, is the concept that since tax liabilities receive certain priorities in bankruptcy court, the courts should make it more difficult to establish those liabilities

than under applicable non-bankruptcy law. The court explained at 83 F.3d 1045: "Since tax claims already receive a statutory priority over other claims, relieving the Board of its burden of proof would be granting the Board a double benefit . . . ." This reasoning is faulty. The court missed the point, when it discusses "relieving the Board of *its* burden of proof," that said burden of proof is one which the courts created. By fashioning its result as denying a "double benefit" or refusing to "relieve" the taxing authority of "*its* burden of proof," the court avoids the more accurate characterization of this ruling: creating equitable impediments for a certain class of creditors based upon the notion that Congress has given them too much.

This Court recently reminded the lower courts that this type of reasoning amounted to an unwarranted invasion by the courts into the legislative function. *U.S. v. Noland*, 116 S.Ct. 1524, 1527-28 (1996). The inappropriate use of so-called equitable principles to override legislatively created rights is even more obvious in this proceeding than in *Noland*. There is simply no basis in law or logic for courts to eliminate one benefit which the law provides to a creditor because Congress has also provided the creditor with a different benefit. The effect of the opinion below is not merely to deny California *one* of its benefits; by making it more difficult to establish the liability, the court has effectively eviscerated any benefit which Congress provided to California with respect to that liability.

The opinion below strikes at the heart of tax administration. The basis of taxation in this country, both at the state and federal level, is voluntary compliance, which involves requiring the taxpayer to accurately and honestly report income or revenues and to maintain and retain records substantiating his position in the event of any contest of the tax liability. Taxing authorities are concerned with the widely-held belief that the treatment accorded to taxes in the Bankruptcy Code is

particularly favorable. In state-court receivership proceedings, state and federal taxes are not paid eighth as they are under the bankruptcy code, Code § 507(a)(8), they are generally paid first. *N.M. College of Agric. & Mechanic Arts v. Academy of Aviation, Inc.*, 83 N.M. 86, 488 P.2d 343 (1971). Taxes can be, and indeed often are, discharged under the bankruptcy code unless they fall within a recognized exception. *See* Code §§ 523(a)(1) (providing an exception to discharge for some tax liabilities), 727(b) (providing that a chapter 7 discharges all debts not within a § 523 exception) and 1328(a) (providing no exception to discharge for tax liabilities; tax liabilities completely dischargeable in chapter 13).[6] One reason Congress has given a higher statutory priority to taxes than, for instance, debts owed to trade creditors, is that taxing authorities cannot choose to whom they extend credit and to whom the government extends services, let alone vary interest rates based upon the risk of default or the quality of the collateral. And unlike other involuntary creditors, such as tort claimants, there is seldom any insurance policy to which the government can resort to collect the involuntarily incurred debt. The reason for giving taxes some special protections in bankruptcy is clearly a reasoned judgment of Congress, and it should be respected. Certainly, nothing in the bankruptcy code gives any foundation to the court's conclusion that tax liabilities are to be given less favorable treatment when the liability is disputed by the debtor.

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[6] Although Code § 1322(a)(2) requires that certain "priority" taxes (*e.g.*, trust fund taxes or recently incurred income taxes) must be paid in full over time without interest, reported cases to date have held that a confirmed plan may nevertheless eliminate even those taxes without any payment if a plan which purports to do so is confirmed or the taxing authority misses a proof of claim deadline. *See In re Tomlan*, 102 B.R. 790 (E.D. Wash. 1989), *aff'd* 907 F.2d 114 (9th Cir. 1990) (collecting cases). *See also, In re Lee*, 184 B.R. 257 (W.D. Va. 1995).

II. THE COURT SHOULD GRANT CERTIORARI BECAUSE THE OPINION BELOW COULD WREAK HAVOC ON STATE AND FEDERAL TAX ADMINISTRATION AND PROMOTE FORUM SHOPPING IN TAX CASES

Cases frequently arise in bankruptcy court where a pre-petition audit discovers unreported income or receipts. Often the taxpayer then claims that, even though the revenue was understated, the taxpayer is entitled to a deduction which the auditor did not recognize. The taxpayer then files bankruptcy. The taxpayer makes thinly-substantiated statements as to its expenses or as to the nature of its sales activity, and asserts that the taxing authority has to disprove these assertions. Disproving a deduction is nearly impossible, unless the taxing authority discovers all of the financial records of the taxpayer and then spends hundreds of hours reconstructing them. In a non-bankruptcy tax proceeding, taxpayers' assertions of fact that are not backed by documentation are given little weight. In bankruptcy court, however, assertions may be enough if the decision below stands. The result is that the Congressional protections given to tax liabilities in bankruptcy court are rendered illusory whenever there is any dispute as to the amount of those liabilities.

If Mr. Macfarlane had chosen to exercise his administrative remedies under California law prior to filing bankruptcy, he would, of course, have been subject to the California standards of proof. Whatever resulted from that proceeding would be binding upon the bankruptcy court. Code § 505(a)(2)(A). *See City Vending of Muskogee v. Oklahoma State Tax Commission*, 898 F.2d 122 (10th Cir. 1990). The resulting liability would be subject to the prioritization and dischargeability provisions of bankruptcy code. The opinion below, if upheld, will create a

positive incentive to file bankruptcy instead of exercising one's administrative remedies under substantive tax law, not because of the bankruptcy law's treatment of that liability but because the bankruptcy court will provide a more favorable forum for the taxpayer to litigate with the government as to the extent of that liability. This cannot be what Congress intended when it enacted the innocuous phrase "the court may determine the amount . . of any tax" in Code § 505(a)(1). Indeed, the relationship between Code § 505(a)(1) (court may determine tax liability) and § 505(a)(2)(A) (court may not determine tax liability if the tax was contested in a judicial or administrative proceeding prior to bankruptcy) would lead to the ordinary conclusion that Congress intended that there should be no difference in the analysis or the outcome when taxes are litigated in bankruptcy.

Moreover, it is doubtful that Congress intended the anomalous situation in which the very same claim adjudication proceeding would be subject to different burdens of proof depending upon whether the bankruptcy court abstained from hearing the proceeding and deferred to a state adjudication, which the law permits in some circumstances and requires in other circumstances. *See* 28 U.S.C. § 1334(c). Under the doctrine enunciated by the court below, a debtor could oppose an abstention motion on the basis that the debtor is more likely to lose in a state proceeding! Such a rationale, while absurd, seems to be dictated by the court's decision based upon the purported "policy considerations that underlie the bankruptcy code," 83 F.3d at 1045.

The ruling that a court should interpret federal law as creating impediments to state tax law is directly contrary to this Court's precedent. In *National Private Truck Council, Inc. v. Oklahoma Tax Commission, et. al*, 115 S.Ct. 2351 (1995), the Court noted that federal laws must be construed against "the

background presumption that federal law generally will not interfere with administration of state taxes . . . ." *Id.*, at 2355. The Court noted that "Congress and [the Supreme Court] repeatedly have shown an aversion to federal interference with state tax administration." *Id.*, at 2354. In the bankruptcy context, this Court has referred to 28 U.S.C. § 960, although not directly applicable in that particular proceeding, as indicating "a Congressional purpose to facilitate--not to obstruct--enforcement of state laws." *Cal Bd. of Equalization v. Sierra Summit*, 490 U.S. 844, 852-53 (1989). In *Sierra Summit*, the Court reversed the Ninth Circuit which ruled that bankruptcy sales were not subject to state sales tax. The court of appeals had ruled that since 28 U.S.C. § 960 did not specifically make the sales subject to tax, federal bankruptcy principles of equity required that they not be taxed. The Supreme Court ruled that the court of appeals erred in ruling that the existence of one statute benefiting state taxes indicated that all other legal benefits in bankruptcy court were implicitly eliminated. The Court concluded that "[i]f Congress wished to declare otherwise, its intent would have to be 'clearly expressed, not left to be collected or inferred from disputable considerations of convenience in administering the estate of the bankrupt.'" *Id.*, at 854. *Compare Macfarlane*, 83 F.3d at 1045 ("In the absence of statutory directive, we consider it appropriate to turn to policy considerations that underlie the bankruptcy code.") *with Landbank*, 973 F.2d at 271 (The bankruptcy court's role as a court of equity "does not confer on the court unlimited authority to ignore plain statutory requirements and to alter the substantive rights of the parties.").

III. CALIFORNIA CORRECTLY PERCEIVED THAT THE NINTH CIRCUIT'S STATEMENTS REGARDING SUMMARY JUDGMENT DID

NOT CREATE A SEPARATE ISSUE
RIPE FOR CERTIORARI REVIEW

After first stating that it agreed with the debtor that this was not a summary judgment case, and after ruling on the burden of proof issue, the court stated that even assuming that the case was tried on summary judgment that the debtor should prevail because the Board did not present sufficient evidence to meet its burden of proof of responding to the summary judgment motion. If a trial court erroneously assumes that the ultimate burden of proof is on the non-moving party, and grants summary judgment for the movant, this is grounds for reversal. *Calderone v. U.S.*, 799 U.S. 254, 258-59 (6th Cir. 1986) (reversing a summary judgment against the IRS entered on the erroneous belief that the IRS had the burden of proof). *See also, A.C. Aukerman V. R.L. Chaides Construction*, 960 F.2d 1020, 1039 (Fed. Cir. 1992). It is substantially more difficult to acquire summary judgment if the moving party has the ultimate burden of persuasion at trial. *See Fontenot v. Upjohn Co.*, 780 F.2d 1190, 1193-96 (5th Cir. 1986). *See also Data Gen. v. Grumman Sys. Support*, 36 F.3d 1147, 1159 (1st. Cir. 1994); *Elkins v. Richardson-Merrell*, 8 F.3d 1068, 1071 (6th Cir. 1993).

The difficulty of acquiring summary judgment when the moving party has the ultimate burden of persuasion is that "in ruling on a motion for summary judgment, the judge must view the evidence presented through the prism of the substantive evidentiary burden. This conclusion is mandated by the nature of the determination." *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 254 (1986). By ruling on the substantive evidentiary burden first, the court below was following the guidance of *Anderson*. However, because the court below looked through the wrong prism, remand is necessary to give the court an opportunity to reconsider its ruling. In any event, as the court

below recognized, this is not a summary judgment case, and any tangential issues respecting the summary judgment procedures on remand are more appropriately to be construed by the court below.

CONCLUSION

For all of the foregoing reasons, amici States respectfully request that the Court grant certiorari in this case.

Respectfully submitted,

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No. 96-235

In The

Supreme Court of the United States

October Term, 1995

FRANCHISE TAX BOARD OF THE STATE OF CALIFORNIA,

Petitioner,

v.

STEPHEN B. MACFARLANE,

Respondent.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

REPLY TO RESPONDENT'S BRIEF

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REPLY TO RESPONDENT'S BRIEF

Petitioner, Franchise Tax Board of the State of California ("Petitioner") submits this reply to the Brief of Respondent, Stephen B. Macfarlane ("Respondent").

Petitioner is not requesting this Court to review evidence.

Petitioner is asking this Court to correct the erroneous rule of law applied to the evidence by the Ninth Circuit and to remand the case back to the lower court so that the correct rule of law can be applied to the evidence.

Pursuant to rule 15.6, petitioner relies upon its petition and upon the amicus brief filed by New Mexico and 23 other states to establish that there is a clear conflict in the circuits on an important federal question.

ARGUMENT

I.

RESPONDENT'S OPPOSITION CONTAINS INACCURACIES WHICH NEED TO BE CORRECTED

Statements contained in respondent's opening brief do not comport with the facts set forth in the record.

Respondent contends that the audit of the Franchise Tax Board was based upon a federal audit which the federal government abandoned. (RBO[1] at p. 2.) Respondent is in error. The record reflects that the federal government was paid $250,000 to settle their claim on this allegedly abandoned audit.

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[1] The designation RBO refers to Respondent's Brief In Opposition.

The respondent opines that the Fourth Circuit's holding with respect to the burden of proof issue in *Landbank Equity Corp. (Internal Revenue Service v. Levy)*, 973 F.2d 264 (4th Cir. 1992) is dicta on the alleged basis that "no evidence was presented to rebut the tax claim." (RBO at pp. 2, 4.) Respondent is incorrect. In *Landbank (Levy)*, the opinion states, "given the state of the debtors' financial records '[i]t would be impossible for the Trustee to prove the time at which specific debts became worthless.' " (*Landbank*, 973 F.2d at 269.) The opinion shows that in *Landbank* the courts had the financial records presented to them but that the records were insufficient to satisfy the burden of proving the validity of a bad debt deduction.

With respect to respondent's contention regarding the *Landbank (Levy)* decision's burden or proof issue being dicta the language of the opinion itself specifically states: "[T]he sole question presented to us on this appeal is whether, in the context of a bankruptcy proceeding, the burden of showing entitlement to a deduction for bad debts shifts from the taxpayer to the IRS". (*Landbank*, 973 F.2d at 268.)

It is hard to conceive that the resolution of the sole issue presented to a federal appellate court is dicta. (See, RBO at p. 2.)

Respondent also incorrectly contends that, "[f]urthermore, *Levy [Landbank]* recognized that its decision may apply only to federal tax claims inasmuch as it distinguished *California State Board of Equalization v. Official Unsecured Creditors Comm. (In re Fidelity Holding Co., Ltd.)*, 837 F.2d 696, 698 (5th Cir. 1988). . . . " (RBO at p. 4.)

Landbank does not distinguish the Fifth Circuit case. *Landbank* cited that case with a "[b]ut see" signal, indicating that the Fifth Circuit case supported a proposition in conflict with the Fourth Circuit holding. (*Landbank*, 973 F.2d at 271.)

Respondent further contends that in the present matter no burden of proof issue was raised by the record because "no fact was controverted". (RBO at p. 5.) Here again respondent is incorrect. The record, through the admissions of the debtor at his deposition, reflects that many important facts were controverted. The record is replete with admissions contradicting the existence of the very elements necessary to establish entitlement to a valid bad debt deduction under applicable law. There was evidence raising questions as to whether a true debtor-creditor relationship existed, whether the money was an investment or loan, and whether there was a reasonable expectation of repayment. (See, Petition App. 31-34.) As a matter of law all of these factors are relevant to a determination of whether or not there were sufficient grounds for a bad debt deduction. (*26 U.S.C. § 166; Cal. Rev. & Tax Code § 17201.*) Petitioner is not asking this Court to review this evidence. Petitioner and amici states are only asking this Court to resolve the legal issue of which party has the ultimate burden of proving the validity of a tax deduction.

Finally, respondent contends that there was no burden of proof issue raised by the record because "the Petitioner never cited any applicable state standard for burden of proof which applied in the presence of such facts". Under California statutory law, judicially noticeable by any court, in litigating entitlement to a bad debt

deduction the "preponderance of the evidence" standard applies. (*Cal. Evid. Code § 115.*)[2]

II.

THE CONFLICT WITH THE FOURTH CIRCUIT'S DECISION IS NOT DISPELLED BY THE FACT THAT THE FRANCHISE TAX BOARD WAS UNABLE TO MAKE A FINAL ASSESSMENT OF MACFARLANE'S TAX LIABILITY BEFORE COMMENCEMENT OF THE BANKRUPTCY CASE

Respondent contends that no conflict exists and that there is no real issue of burden of proof because the state's proof of claim filed in the estate was not based upon a final tax assessment but only upon a proposed tax assessment which was prevented from becoming final because of the automatic stay. (RBO at pp. i, 2.)

Respondent's contention is incongruous. The Code itself gives priority status to an income tax, "not assessed before, but assessable under applicable law or by agreement, after, the commencement the case." (*11 U.S.C.*

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[2] California Evidence Code § 115 provides in full as follows:

" 'Burden of proof' means the obligation of a party to establish by evidence a requisite degree of belief concerning a fact in the mind of a trier of fact or the court. The burden of proof may require a party to raise a reasonable doubt concerning the existence or nonexistence of a fact or that he establish the existence or nonexistence of a fact by a preponderance of the evidence, by clear and convincing proof, or by proof beyond a reasonable doubt."

"Except as otherwise provided by law, the burden of proof requires proof by a preponderance of the evidence."

§ 507(a)(8)(A)(iii).) "Claim", as defined by the Code, includes a right to payment even if unmatured and/or contingent. (*11 U.S.C. § 101(5).*) Thus the Franchise Tax Board claim was entitled to priority. A claim arising after commencement of a case for a tax that is entitled to priority under section *507(a)(8)* is to be determined and allowed as if such claim had arisen before the date of the filing of the petition. *(11 U.S.C. § 502(i).)* Clearly, unassessed taxes, which are due and owing, but not yet final, fall within the concept of "claim" for which a proof of claim may be filed. (*In re Davidson*, 156 B.R. 600, 603 (Bankr. Ark. 1993).)

Respondent's opposition provides no valid basis for the argument that no conflict with the Fourth Circuit exists because the prepetition taxes at issue had not been the subject of a final assessment before commencement of the bankruptcy proceeding.

III.

A DEBTOR IN POSSESSION OR A TRUSTEE IS ALREADY REQUIRED TO POSSESS RECORDS SUPPORTING THEIR FINANCIAL TRANSACTIONS; NO CHAOS WILL RESULT BY REQUIRING THAT THE DEBTOR OR TRUSTEE COMPLY WITH EXISTING LAW AND PROVIDE EVIDENCE CONSISTENT WITH THE PROPER BURDEN OF PROVING ENTITLEMENT TO A DEDUCTION

The Code provides that it is the debtor's duty to keep and supply accurate financial information. (*11 U.S.C. § 521.*) To require the debtor or the trustee to produce evidence proving entitlement to a bad debt deduction is

in complete accord with existing law and will impose no greater burden than currently exists.

The ability of debtors to discharge their debts is the primary benefit of the bankruptcy system. Section 727(a)(3) of the Code requires, as a precondition to discharge, that debtor or trustee produce records "from which the debtor's financial condition or business transactions might be ascertained. . . . "

Since failure of the debtor or the trustee to produce books and records will result in a debtor failing to receive a discharge, it is not disruptive when applicable substantive law imposes the burden of proof on debtors to produce sufficient books and records to establish the validity of bad debt deductions in bankruptcy claims litigation.

It should not be the task of creditors to spend endless hours gathering evidence when applicable substantive law already requires the debtor (taxpayer) to maintain sufficient records to support their tax deductions. No further policy is served by changing this requirement simply because a taxpayer has decided to file a bankruptcy petition.

Finally, in this particular case the challenge to the tax assessment was not raised by other creditors or the trustee. The dispute was solely between the State of California and the debtor, "Macfarlane", who would be the principal beneficiary of the Ninth Circuit's ruling.

CONCLUSION

The crucial importance of the issue before this Court is demonstrated by the fact that twenty-four amici states filed a brief in support of the petitioner. This Court is urged to accept this case in order to resolve a clear conflict between the circuits on this important issue.

Respectfully submitted,

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Supreme Court, U.S.
FILED
DEC 30 1996
CLERK

No. 96-235

In the Supreme Court of the United States

OCTOBER TERM, 1996

CALIFORNIA FRANCHISE TAX BOARD, PETITIONER

v.

STEPHEN B. MACFARLANE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

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38 pp

QUESTION PRESENTED

Whether the government has the burden of proving that a taxpayer is not entitled to a deduction when an income tax claim is litigated in a bankruptcy case.

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In the Supreme Court of the United States

OCTOBER TERM, 1996

No. 96-235

CALIFORNIA FRANCHISE TAX BOARD, PETITIONER

v.

STEPHEN B. MACFARLANE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

This brief is submitted in response to the Court's order inviting the Solicitor General to express the views of the United States.

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1-11) is reported at 83 F.3d 1041. The opinion of the district court (Pet. App. 13-34) and the opinion of the bankruptcy court (Pet. App. 35-42) are unreported.

STATUTORY PROVISIONS AND RULES INVOLVED

In addition to the provisions of the Bankruptcy Code, the Federal Rules of Bankruptcy Procedure and the Internal Revenue Code that are set forth at Pet. App. 44-52, the following statutory provisions are involved in this case:

1. 28 U.S.C. 158 provides, in relevant part:

> (a) The district courts of the United States shall have jurisdiction to hear appeals
>
> (1) from final judgments, orders, and decrees;
>
> * * * * *
>
> and, with leave of the court, from interlocutory orders and decrees, of bankruptcy judges entered in cases and proceedings referred to the bankruptcy judges under section 157 of this title. * * *
>
> * * * * *
>
> (d) The courts of appeals shall have jurisdiction of appeals from all final decisions, judgments, orders and decrees entered under subsections (a) and (b) of this section.

2. 28 U.S.C. 1291 provides, in relevant part:

> The courts of appeals (other than the United States Court of Appeals for the Federal Circuit) shall have jurisdiction of appeals from all final decisions of the district courts of the United States, * * * except where a direct review may be had in the Supreme Court.

STATEMENT

The United States adopts the Statement contained in the Petition with the following additions:

1. a. After the debtor filed his objection to the state tax claim, a hearing was held by the bankruptcy court on March 15, 1993. At that hearing, the bankruptcy court announced its conclusion that (i) the

proof of claim filed by the state agency "is prima facie valid under the Bankruptcy Rules" but (ii) that the debtor had filed "competent evidence" that would support a conclusion that no tax was owed and (iii) that "the prima facie validity" of the tax claim therefore "has been rebutted" (App., *infra*, 2a-3a). The court then held that the ultimate burden of "proving by a preponderance of the evidence the factual basis for [the tax] claim" rests on the state agency rather than on the debtor (*id.* at 3a).

Having determined that the burden of proof on the tax claim rests ultimately on the state agency, the court concluded that (App., *infra*, 3a)

> there ought to be a window of time in which the [state agency] is allowed to conduct subsequent discovery as it believes it needs to support its claim. And then we'll have an evidentiary hearing and determine what the allowed amount of the claim should be.

The court set "a status conference" for the case for July 12, 1993 (*id.* at 5a).

b. Before the date of the status conference, the debtor filed a motion for summary judgment on his objection to the state tax claim (Pet. App. 15-16). That motion, which was accompanied with documentary evidence and deposition testimony, contained a statement of the uncontroverted facts that the debtor claimed entitled him to summary judgment (App., *infra*, 17a). The motion was opposed by the state agency, which relied on the same materials submitted by the debtor (Pet. App. 15-16).

At the status conference held on July 12, 1993, the court announced that "[t]he uncontroverted facts in this record" (App., *infra*, 8a) support the conclusion

that no tax is owed. The court stated that if there had been "controverting facts" it might have reached a different conclusion but that "the uncontroverted evidence at this point in time" required judgment to be entered in the debtor's favor on his objection to the state tax claim (*ibid.*). In explaining its ruling at the July 12 hearing, the court stated (*id.* at 17a):

> I went through the list of the assertedly uncontroverted facts set out in exhibit 1 to the notice of this motion filed by the debtor and found that I could agree with each of those based upon the statements I've already made * * *.

Having thus ruled on the "motion filed by the debtor," the court directed the debtor's counsel to "prepare a proposed formal order" (*ibid.*).

The formal order thereafter entered by the bankruptcy court states (Pet. App. 41):

> The California Franchise Tax Board has had an adequate opportunity for discovery. The only evidence has been offered by the Debtor. * * * The evidence offered by the Debtor is not controverted by the California Franchise Tax Board. Accordingly the Court concludes that there is no issue of material fact raised by the evidence before the Court which is in reasonable dispute.

Expressing the view that the uncontroverted facts require the conclusion that no tax was owed, the court entered judgment in the debtor's favor on the state tax claim (*ibid.*).

2. On appeal, the district court agreed with the bankruptcy court that the state agency has the ultimate burden of proof on state tax claims in bankruptcy cases (Pet. App. 23). The district court fur-

ther stated that, on the record before it, the "findings of fact" recited in the bankruptcy court's order were not clearly erroneous (*id.* at 25-30). The district court concluded, however, that the state agency presented evidence that "creates a genuine issue of triable fact" on these material facts and that summary judgment was therefore inappropriate (*id.* at 31). The court explained (*id.* at 32):

> Although the [state agency] has the ultimate burden of proof to establish to what extent the funds advanced * * * were for the purpose of a tax shelter, the Board has pointed to sufficient evidence in the record to create a triable issue that some of the funds were not loans and were used to generate a tax loss.

"Viewing all inferences that can be drawn from the excerpts of the record * * * in a light most favorable to the [state agency]," the district court held that material issues of fact were in genuine dispute (*id.* at 34) and therefore "reverse[d] the bankruptcy court's grant of summary judgment" (*ibid.*).

3. Both the debtor and the State appealed. The court of appeals noted that there is "a jurisdictional concern that the district court's reversal of the bankruptcy court's judgment is not a final order because further proceedings in bankruptcy court are contemplated" (Pet. App. 6). Taking what it described as "a pragmatic approach," the court held that it would assume jurisdiction in this case even though the district court's order "remands for further proceedings in the bankruptcy court" (*id.* at 6-7).

Reaching the merits, the court of appeals agreed with the analysis and conclusions of the bankruptcy court and directed that judgment be entered in the

debtor's favor (Pet. App. 7-11). In so ruling, the court expressed uncertainty as to whether the case had been decided below after an evidentiary hearing or on summary judgment. The court of appeals suggested that an evidentiary hearing may have occurred because the findings of fact recited in the order of the bankruptcy court appear to have "resolved factual disputes" (*id.* at 10). The court stated that, on the record before it, the findings recited in the bankruptcy court order "are not clearly erroneous" (*ibid.*). The court further held that, "even if summary judgment standards are applied [in this case], we agree with debtor that the bankruptcy court's decision should be affirmed" because no "genuine issues of material fact" exist (*id.* at 11). The court of appeals therefore reversed the judgment of the district court and remanded for entry of judgment in favor of the debtor (*ibid.*).

DISCUSSION

The holding of the court of appeals that the taxing authority has the burden of proof on tax claims in bankruptcy cases is in direct conflict with decisions of other circuits. This case does not provide a suitable vehicle for resolving the conflict on this important and recurring question, however, for the court of appeals lacked jurisdiction over the appeal from the district court order that denied summary judgment in this case. In bankruptcy litigation, as in other civil litigation, an order denying a motion for summary judgment on the ground that material issues of fact remain in genuine dispute is not a "final" order from which an appeal may be taken.

Because the court of appeals lacked jurisdiction, the judgment should be vacated and the case remanded

to the bankruptcy court for further proceedings pursuant to the order of the district court. Petitioner, however, has not suggested that the absence of jurisdiction in the court of appeals is a basis for this Court's review of the decision below. And, the question that *is* framed in the petition—the proper allocation of the burden of proof on tax claims in bankruptcy cases—is not appropriate for review on this petition because the court of appeals had no jurisdiction to consider it.

1. The court of appeals correctly noted that its holding that the taxing authority has the burden in bankruptcy cases of proving the correctness of a tax determination is consistent with the decisions of three other courts of appeals (Pet. App. 8, citing *In re Placid Oil Co.*, 988 F.2d 554, 557 (5th Cir. 1993); *In re Gran*, 964 F.2d 822, 827-828 (8th Cir. 1992); *In re Fullmer*, 962 F.2d 1463, 1466 (10th Cir. 1992) (dictum); see also *In re Brown*, 82 F.3d 801, 805 (8th Cir. 1996) (dictum)) but conflicts with the decisions of two other circuits (Pet. App. 8, citing *Resyn Corp.* v. *United States*, 851 F.2d 660, 663 (3d Cir. 1988); *IRS* v. *Levy (In re Landbank Equity Corp.)*, 973 F.2d 265, 268-272 (4th Cir. 1992)).[1] This direct conflict among the cir-

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[1] The decisions of the lower courts reflect the division among the circuits. Compare, *e.g.*, *In re Wilhelm*, 173 B.R. 398 (Bankr. E.D. Wis. 1994); *In re Federated Department Stores, Inc.*, 135 B.R. 950, 957-958 (Bankr. S.D. Ohio 1992), aff'd, 171 B.R. 603, 607 (S.D. Ohio 1994); *In re Premo*, 116 B.R. 515 (Bankr. E.D. Mich. 1990); *United States* v. *Coleman American Cos.*, 26 B.R. 825 (Bankr. D. Kan. 1983) (tax authorities, like other creditors, must bear burden of proof to establish their claims), with, *e.g.*, *Cobb* v. *United States*, 135 B.R. 640, 641 (Bankr. D. Neb. 1992); *In re Tripplett*, 115 B.R. 955, 964 n. 11 (Bankr. N.D. Ill. 1990); *United States* v. *Terrell*, 75 B.R. 291

cuits concerns a recurring issue of substantial importance to the administration of the tax laws.

a. In litigation involving federal tax liabilities, the taxpayer bears the ultimate burden of persuasion.[2] More than sixty years ago, this Court stated in *Helvering* v. *Taylor*, 293 U.S. 507, 515 (1935), that "[u]nquestionably the burden of proof is on the taxpayer to show that the commissioner's determination is invalid." See also *Welch* v. *Helvering*, 290 U.S. 111, 115 (1933). As the First Circuit has recently explained, "[t]he rationale for this rule is more deeply rooted than the conventional regimen that places the burden of proof on the moving party." *Delaney* v. *Commissioner*, No. 95-2066 (Nov. 1, 1996), slip op. 6:

> The Supreme Court has held that the Commissioner's "ruling has the support of a presumption of correctness, and the petitioner has the burden of proving it to be wrong." *Welch* v. *Helvering*, 290 U.S. 111, 115 (1933); *see also United States* v. *Janis*, 428 U.S. 433, 439 (1976); *Estate of Todisco* v. *Commissioner*, 757 F.2d 1, 6 (1st Cir. 1985) (the basic rule in all tax cases places the burden of proof with the taxpayer). * * * [I]n a tax deficiency suit "the burdens of going forward and of ultimate persuasion are

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(N.D. Ala.), aff'd without opinion, 835 F.2d 1439 (11th Cir. 1987) (burden of proof is governed by applicable nonbankruptcy law and, in tax cases, burden lies with taxpayer).

[2] The party who bears the burden of proof in litigation bears the ultimate burden of persuasion or the risk of nonpersuasion. 9 J. Wigmore, *Evidence* § 2485 (J. Chadbourn rev. 1981). Although the burden of production may shift during the course of a lawsuit, the burden of proof is fixed as a matter of law and never shifts. *Id.* § 2489.

> always on the taxpayer and never shift to the Commissioner." [*United States* v. *Rexach*, 482 F.2d 10, 16-17 (1st Cir.), cert. denied, 414 U.S. 1039 (1973).]

The present case involves a claim for additional state income taxes arising from the disallowance of asserted bad debt deductions. In cases involving federal taxes, it is well established that the taxpayer always bears the burden of proof in establishing a claim of entitlement to a deduction. See, *e.g.*, *Bull* v. *United States*, 295 U.S. 247, 260 (1935); *Burnet* v. *Houston*, 283 U.S. 223, 227-228 (1931).[3] This same allocation of the burden of proof to the taxpayer applies under the state law applicable to the state tax involved in this case (Pet. App. 7, citing *Krumpotich* v. *Franchise Tax Bd.*, 31 Cal. Rptr.2d 896, 899 (1994)) and, evidently, under the laws of all other States (Am. State of Arizona, et al., Br. 5 n.2).

b. The court of appeals erred in this case in concluding that this burden of proof should be shifted from the taxpayer to the government simply because the tax issue arises in the bankruptcy context. As this Court noted in *Bull* v. *United States*, 295 U.S. at 260, the usual procedure for recovery of debts is "reversed" in the field of taxation in that "the burden of proof, normally on the claimant, is shifted to the taxpayer." This allocation of the burden of proof in tax cases is governed by substantive law, not by any rule of bankruptcy procedure. *In re Landbank Equity*

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[3] In federal tax cases litigated outside of the bankruptcy context, the Ninth Circuit has routinely adhered to that rule. See, *e.g.*, *Betson* v. *Commissioner*, 802 F.2d 365, 367 (1986); *Rockwell* v. *United States*, 512 F.2d 882, 885-886, cert. denied, 423 U.S. 1015 (1975).

Corp., 973 F.2d at 269-271. See 21 C. Wright & K. Graham, *Federal Practice and Procedure* § 5122 (1977).

The court of appeals acknowledged that "[t]he bankruptcy code is silent on the allocation of the ultimate burden of proof in this case" (Pet. App. 9).[4] Because there is no "clear and manifest" (*BFP* v. *Resolution Trust Corp.*, 511 U.S. 531, 544 (1994)) indication in the Bankruptcy Code of any intent to displace substantive state and federal law in the enforcement of tax claims, allocation of the burden of proof to the taxpayer under the applicable provisions of substantive law should not have been discarded by the courts below.

The court of appeals sought to justify its decision in this case as an effort to "balance the equities 'between the Board and the other creditors of Debtor's estate'" (Pet. App. 9). But the court's concerns about "equities" between claimants does not justify a refusal to enforce substantive state and federal tax law. Here, as in *Butner* v. *United States*, 440 U.S. 48,

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[4] Neither 11 U.S.C. 502 of the Bankruptcy Code, which governs the allowance of claims generally, nor 11 U.S.C. 505, which authorizes the bankruptcy courts to adjudicate tax disputes, contains any provision regarding allocation of the burden of proof. Compare 11 U.S.C. 362(g) (assigning burden of proof in challenges to automatic stay); 11 U.S.C. 363(*o*) (in hearing on use of property, assigning burden on adequate protection to trustee); 11 U.S.C. 364(d)(2) (in hearing on obtaining credit, assigning trustee burden on adequate protection issue); 11 U.S.C. 547(g) (assigning burden with respect to avoidability of certain allegedly preferential transfers); 11 U.S.C. 1129(d) (assigning to government burden of proving claim of tax avoidance as principal purpose of plan). See also Fed. R. Bankr. P. 4003(c) (party objecting to exemption bears burden); Fed. R. Bankr. P. 4005 (burden assigned to party objecting to discharge).

56 (1979), "undefined considerations of equity provide no basis for adoption of a uniform federal rule" in bankruptcy that departs from generally applicable rules of substantive law. Furthermore, as Amici State of Arizona, et al., explain (Am. Br. 9-10), the burden of proof has been assigned to the debtor in *non*-tax disputes in bankruptcy cases when applicable nonbankruptcy law assigns that burden to the party in the debtor's position. See, *e.g.*, *In re Unioil, Inc.*, 962 F.2d 988, 994 (10th Cir. 1992) (debtor had burden of proving accord and satisfaction as mandated by applicable state law). It is thus not a special dispensation to taxing authorities in bankruptcy cases to apply the rules allocating the burden of proof that are established under substantive, nonbankruptcy law. Instead, it is a distinctive discrimination against the taxing authority to refuse to apply the allocation rules established under applicable nonbankruptcy law.

c. The proper allocation of the burden of proof on tax claims in bankruptcy cases is an issue of substantial recurring importance in the administration of the tax laws. The Internal Revenue Service files more than 100,000 proofs of claim in bankruptcy cases each year seeking to recover several billion dollars of taxes. If the Service were required to bear the burden of proof on tax claims in bankruptcy cases, it would potentially be necessary for the government to engage in substantial discovery and case preparation in vast numbers of cases to meet pro forma objections that the government must "prove up its case." Such a requirement can not be reconciled with this Court's holding in *Bull* v. *United States*, 295 U.S. at 260, that "the usual procedure for the recovery of debts is reversed in the field of taxation" and that "the burden

of proof, normally on the claimant, is shifted to the taxpayer."

A rule that allowed taxpayers in bankruptcy to avoid the burden of proof would encourage abusive use of the bankruptcy courts. It would make bankruptcy a favorable arena in which to defend questionable deductions and would materially impede the effective enforcement of the revenue laws.

2. In its present posture, this case is not a suitable vehicle for resolving the important and recurring question of the proper allocation of the burden of proof on tax claims in bankruptcy cases. Although the proceedings that occurred in the bankruptcy court are not clearly reflected in the orders of the courts below, it appears from examination of the record that (i) the debtor moved for summary judgment on his objection to the state tax claim, (ii) the bankruptcy court granted summary judment to the debtor based upon the "uncontroverted facts set out in * * * this motion" (App., *infra*, 17a), and (iii) the form of order prepared by debtor's counsel, and entered by the court, contained both a recitation of "findings" and a statement by the bankruptcy court that "[t]he evidence offered by the Debtor is not controverted" and "that there is no issue of material fact" for the court to resolve (Pet. App. 41). On appeal from that order, the district court reversed the grant of summary judgment by the bankruptcy court because there was "sufficient evidence in the record to create a triable issue" on the tax claim (*id.* at 32) and material issues of fact thus remained in genuine dispute (*id.* at 34).

The posture of the case at the conclusion of these proceedings in the district court was thus simply that a motion for summary judgment had been denied. A

district court order that denies a motion for summary judgment on the ground that material issues of fact remain in controversy is not a "final" order from which an appeal may be taken under 28 U.S.C. 158(d) or 28 U.S.C. 1291. See, *e.g.*, *In re Caravansary, Inc.*, 821 F.2d 1413, 1414 (9th Cir. 1987); *In re TCL Investors*, 775 F.2d 1516, 1519 (11th Cir. 1985); *In re Goldblatt Bros.*, 758 F.2d 1248, 1250-1251 (7th Cir. 1985); *In re Bacchus*, 718 F.2d 736, 737 (5th Cir. 1983).[5]

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[5] The court of appeals cited several decisions from its circuit that embody what the court described as a "pragmatic approach" to the finality question (Pet. App. 6). Those cases, however, are inapposite. For example, in *In re Dominguez*, 51 F.3d 1502 (9th Cir. 1995), the court stated that, "[a]lthough we ordinarily lack jurisdiction when the lower appellate decision remands for further factual findings related to a central issue raised on appeal, we may assert jurisdiction if the appellate 'issue is *legal* in nature and its resolution either 1) could dispose of the case or proceeding and obviate the need for factfinding; or 2) would materially aid the bankruptcy court in reaching its disposition on remand.'" *Id.* at 1506-1507, quoting *In re Bonner Mall Partnership*, 2 F.3d 899, 904 (9th Cir. 1993), cert. dismissed, 513 U.S. 18 (1994). The issue decided in the courts below in the present case, however, was whether material issues of fact were in genuine controversy—which was a factual, not legal, issue. There was no legal dispute about whether the issues of fact, if in genuine controversy, would be material. Thus, even under the Ninth Circuit's "pragmatic" approach, the court of appeals lacked jurisdiction because "the lower appellate decision remands for further factual findings related to a central issue raised on appeal" (*ibid.*). See *In re Caravansary, Inc.*, 821 F.2d at 1414.

Moreover, the Ninth Circuit's overall attempt to craft a special, "pragmatic" approach to the question of finality in bankruptcy cases has been a highly dubious enterprise. The decisions cited by the court of appeals in this case (Pet. App. 6-7) suggest an effort to apply criteria similar to those governing interlocutory appeals under 28 U.S.C. 1292(b). But, while the

The court of appeals therefore lacked jurisdiction over the appeal in this case.

Because the court of appeals lacked jurisdiction, the issue of the proper allocation of the burden of proof should not have been reached on appeal. Instead, the appeal should have been dismissed. Because the appeal should have been dismissed, this case does not present an appropriate opportunity for this Court to review the decision below on the merits. In particular, the question presented in the petition for a writ of certiorari cannot properly be addressed in this case at this time.

The relief that would be appropriate in this context would be an order vacating the judgment of the court of appeals for lack of jurisdiction and remanding the case to the bankruptcy court for further proceedings. Although petitioner has not requested such relief, it would, in our view, be useful (see note 5, *supra*).

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latter category of appeals are clearly optional and discretionary in nature, a party is placed at a substantial risk of losing its right to appeal under the Ninth Circuit's "pragmatic" approach if it forgoes taking an immediate appeal from a seemingly interlocutory order in bankruptcy that may meet the Ninth Circuit's flexible standard of finality. Hence, the erosion of a reliable finality criterion tends to spawn appeals from interlocutory orders—as in the present case.

CONCLUSION

The petition for a writ of certiorari should be denied or, if granted, the judgment of the court of appeals should be vacated for lack of jurisdiction and the case remanded for further proceedings. If the case is set for briefing and argument, the parties should be asked to address, in addition to the question presented in the petition, whether the court of appeals lacked jurisdiction in this case.

Respectfully submitted.

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DECEMBER 1996

APPENDIX A

[167]

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF CALIFORNIA

U.S. Courthouse
940 Front Street
San Diego, California 92189
Department No. 4

IN THE MATTER OF: STEPHEN MACFARLANE,
DEBTOR

HEARING RE: OBJECTION TO CLAIM

March 15, 1993

REPORTER'S TRANSCRIPT OF PROCEEDINGS

Hon. PETER W. BOWIE, Judge

Federal Court Reporting
By: Kathleen Cheyne
940 Front Street
San Francisco, California 92189
(619) 726-8053

* * * * *

[169]

San Diego, California - Monday, March 15, 1993 - 2:30 P.M.

* * *

The Clerk: 90 11375, Stephen Macfarlan, objection to claim.

The Court: Appearances.

Mr. Martin: Good afternoon, your Honor. Elmer Martin appearing for the debtor.

Mr. Sgherzi: Good afternoon, your Honor. Anthony Sgherzi, Deputy Attorney General, appearing on behalf of the State Board of Equalization.

The Court: Mr. Sgherzi. Would you like a preliminary assessment?

Mr. Sgherzi: That would be helpful.

The Court: All right. I've reviewed the volum[e]s of moving and opposing papers, and where I come out is as follows on the threshold issues. It appears to me as follows: first off the franchise tax board has filed a proof of claim. Their proof of claim is prima facie valid under the bankruptcy rules and therefore is treated that way. The debtor has filed an objection to claim. The debtor has provided competent evidence tending to challenge that there was in fact a debt that existed in 1988 and 1989. Further the debtor has provided competent evidence to establish that the debt was worthless in 1988 and 1989.

What that means then as far as this court is concerned is that the presumption of validity, the prima facie validity, of F.T.B.'s claim has been rebutted. Now we get to [170] the issue that always divides the taxing authorities and debtors; and that is who has the burden at this juncture.

Do we have the non-bankruptcy burden or do we have the bankruptcy burden. It is this court's view after having reviewed a number of cases over the last several years in which this issue has been tested that in fact in the bankruptcy arena the taxing authority having submitted a proof of claim is a claimant or creditor claimant like other creditor claimants and therefore has the burden once the prima facie validity has been rebutted, proving by a preponderance of evidence the factual basis for its claim.

Now, having concluded that and because the burden issue is a threshold issue that needs to be resolved, it's my view that there ought to be a window of time in which the franchise tax board is allowed to conduct subsequent discovery as it believes it needs to support its claim. And then we'll have an evidentiary hearing and determine what the allowed amount of the claim should be.

All right. Who wants to be heard first? Mr. Martin, you want to be heard? It's your objection to claim. You agree with everything except giving him a window of time to conduct discovery.

Mr. Martin: Well, I don't—Actually I don't disagree with anything your honor said. I don't know of anything that they're going to find that we haven't put in the papers we've already put forward, but we're

willing to make time available to them, if that's the court's wish.

The Court: Mr. Sgherzi.

[171]

Mr. Sgherzi: Your Honor, based on the court's preliminary assessment, I would appreciate at least the opportunity to see if we can somehow persuade the court that there's merit in the points and authorities that we filed in terms of not only the burden but actually the underlying evidence to sustain that.

The Court: Well, I've made my threshold rulings. So at this point in time the burden is yours to prove it. What window of time do you think will be reasonable for you? Do you think we can take 30 days to review it and we hold a status conference in 30 days or something?

Mr. Sgherzi: If we are going to do discovery, naturally we'll probably do depositions or requests for production of certain documents and so on. I would like rather than have to come back here and continue to expend time, I would say 90 days should be a reasonable amount of time in which we can either conclude that we have something or we don't.

The Court: All right. With respect to the burden issue, I understand the arguments on both sides and have faced it before, particularly with the I.R.S., and this is where I come out siding with the primo line of cases, if you will.

Mr. Martin, Can you live with that window?

Mr. Martin: Yes, your honor.

The Court: All right. Why don't we set a status conference for roughly 90 days, and that should not preclude either of you from doing what you feel you need to do in a shorter period of time.

Mr. Sgherzi: Sure.

[172]

The Court: Because everybody has an interest in trying to get this resolved.

The Clerk: July 12th at 2:00 o'clock.

The Court: You want to go all the way to July? That's about 120 days.

The Clerk: June 14th at 2:00 o'clock.

Mr. Martin: Your Honor, I'm going to be out of state on June 14th in a program at Notre Dame on how to try trials in bankruptcy cases so I won't be available on June 14th.

The Clerk: June the 21st at 2:00 o'clock.

Mr. Martin: June 21st I'm serving as a pro team judge in superior court.

The Court: Maybe we ought to go back to July the 12th.

Mr. Martin: What day of the week does that fall on?

The Clerk: Monday.

The Court: July the 12th, 2:00 p.m.

Mr. Martin: That's fine with me.

The Court: Okay.

Mr. Sgherzi: Thank you.

Mr. Martin: Thank you.

[173]

State of California)

County of San Diego)

I, Kathleen Cheyne, a shorthand reporter, do hereby certify that the foregoing hearing was taken before me at the time and place herein named; that said hearing was reported by me in shorthand and then transcribed through computer-aided transcription, and the foregoing transcript contains a true record of the said hearing.

I do further certify that I am a disinterested person and am in no way interested in the outcome of this action.

In witness whereof, I have hereunto set my hand on the 21st day of July, 1993, at San Diego, California.

/s/ KATHLEEN CHEYNE

KATHLEEN CHEYNE

APPENDIX B

[69]

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF CALIFORNIA

U.S. Courthouse
940 Front Street
San Diego, California 92189
Department No. 4

IN THE MATTER OF: STEPHEN MACFARLANE,
DEBTOR

HEARING RE: ORJECTION TO CLAIM AND MOTION FOR SUMMARY DETERMINATION DENYING CALIFORNIA FRANCHISE TAX BOARD CLAIM

July 12, 1993

REPORTER'S TRANSCRIPT OF PROCEEDINGS

Hon. PETER W. BOWIE, Judge

Federal Court Reporting
By: Kathleen Cheyne
940 Front Street
San Diego, California 92189
(619) 726-8053

* * * * *

[71]

San Diego, California - Monday, July 12, 1993 - 2:00 P.M.

* * *

The Clerk: 90 11375, Stephen Macfarlane, objection to claim and motion for summary determination denying California franchise tax board claim.

The Court: Appearances.

Mr. Martin: Good afternoon, your Honor. Elmer Martin appearing for the debtor.

Mr. Sgherzi: Good afternoon, your Honor. Anthony Sgherzi, Deputy Attorney General, appearing on behalf of the Franchise Tax Board.

The Court: Mr. Martin. That's the smallest piece of paper you've gotten in this case, isn't it?

Mr. Martin: And there's nothing on it, too. Well, does your honor have a tentative?

The Court: I do.

Mr. Martin: Could we hear it?

The Court: My view of this proceeding is as follows: that while if I had facts to support it, I might have some question about what went on here as being embezzlement by Mr. Cheng and thus qualifying as a loss rather than a debt.

The uncontroverted facts in this record as established particularly by Ms. Szuetenback in both her declaration and her transcript of her deposition establish that [72] these were loans.

Now, whether if I had controverting facts, I might conclude that if I saw more evidence. I can't say. But the uncontroverted evidence at this point in time is that they were loans.

Now, in as much as they were loans and in as much as we then come upon the question of whether at some point in time they became worthless, is really the controlling question. Because to the extent they were loans, they were an obligation to pay, and that would therefore qualify them as debts, which if they became bad, meaning they became worthless, would entitle the debtor to the deductions that the debtor has claimed.

The amounts have not been challenged. Ms. Szuetenback in her deposition testifies both as to the amounts and as to the evidence of the loans, the additional checks that were—that were other than the ones discussed with Mr. Macfarlane in his deposition. And if you add those up, there's been no facts established to controvert the facts asserted by the debtor with respect to the dollar amounts claimed in either the '88 or '89 tax returns. So the issue then becomes, when did it become worthless.

The state has argued that how can Mr. Macfarlane say it became worthless in '88 when he didn't even know that it became worthless. But we have Mr. Cheng who instructs Ms. Szuetenback to take it as a bad debt loss because he has an [73] inability to pay, that she's got personal knowledge, as does Ms. Joyce, that Mr. Cheng does not have the ability to pay at that point in time.

Under all the circumstances and accepting that whether or not a debt becomes worthless when a debt becomes worthless, is a question of fact. The uncontroverted facts established that it became worthless in '88 as to '88 and by the end of '89 as to '89.

And the next question is, well, but if Mr. Macfarlane didn't owe that, how can he claim that that was in fact worthless. But we have the fact that Mr. Cheng

acknowledges it by directing its inclusion in the '88 and '89 tax returns, but we also have Mr. Cheng having Mr. Macfarlane's power of attorney and the ability to recognize that in the very office where you're preparing Mr. Macfarlane's tax return. So somebody on behalf of Mr. Macfarlane was authorized to and apparently did recognize that in fact the obligations to Mr. Cheng in '88 and again in '89 had become worthless.

Now, the state has suggested that Mr. Macfarlane could have had no expectation of repayment in '89, having signed the '88 tax return because he knew at least at that point in time that there was no way that Mr. Cheng could repay him. Well, one, that fact is not at all clear. Secondly, the date on which the '88 tax return was signed was in October of '89. Third, is that the premise of the state appears to be that the [74] debt had to be a good debt at the start of the year and termed worthless sometime during the year.

In point of fact, we could make a loan to somebody, as banks often do, even at a time when the banks are administratively or accountantwise insolvent, make loans or advances by way of credit card accounts to people who are themselves insolvent and still do it notwithstanding their circumstances. The fact that you could say that I knew that he could not pay back last year's obligations, one does not establish that he couldn't pay back the next year's obligations on new loans made in 1989, but, secondly, there is at least the value advance in the loan amounts which establishes value and at least momentarily inability to repay within that window of time.

So however unreasonable one might say Mr. Macfarlane's expectations were and recognizing that Mr. Macfarlane had a real difficulty distinguishing

between what's a loan and an investment, nevertheless under all the circumstances, it's the court's ruling under a tentative basis, and I'll hear from Mr. Sgherzi on it, that the debtor's motion ought to be granted.

Mr. Martin: Thank you, your Honor.

Mr. Sgherzi: I guess by now the court's pretty familiar, after reading all of these papers, the state's position. I think there are a lot things that are clear. I think—but there are also very many things that are not clear.

[75]

First of all, I think you have to take a look at what the debt is. First of all, we don't have a situation where there was one particular circumstance in which the debtor gave Cheng or any of the associates money. The facts clearly indicate that the debtor provided Cheng and the associates with an all-inclusive power of attorney. Which meant they could have taken the money out at any time; they could have done whatever in fact they wanted to do with it.

Under those circumstances, I don't see how anyone else can indicate that there was an intent on the part of the debtor to make a loan. It just does not add up. Cheng had an all-inclusive power of attorney, and the fact that—

The Court: Well, let me interrupt you for a minute.

Mr. Sgherzi: Sure.

The Court: Because one of the documents on which I rely to establish that is the letter from Mr. Cheng to Mr. Macfarlane in January of '87 which says, you know, we've talked about a loan to me. We've talked about your investing in this information system, which was not Cheng at the time. It was the

other one. Altear (phonetic spelling) I think it was called. But at this point in time we went to treat it as a personal loan and deal with it this way. And as the process of Altear solidifies, then we'll talk about investing. And that's a threshold document which suggests, here is where money is going, [76] this is what Macfarlane understands he's doing and what he thinks he's getting into.

Mr. Sgherzi: Well, I understand that. That probably is in effect to one particular transaction. But my understanding of the way this whole thing went down is that there were multiple transactions over a period of time. I think the evidence shows, and if the court takes look at page seven.

The Court: Of?

Mr. Sgherzi: Of my last—

The Court: Page seven of which document?

Mr. Sgherzi: Responsive creditor franchise tax board's objection to a complaint in the July 2nd document.

It basically indicates that he gave an all-inclusive power of attorney; he had signatory power over all the checking accounts.

Now, when someone says on a particular occasion that money is being used for purposes of a loan, I don't think you can assume that that money is being used for purposes of a loan with respect to every transaction which takes place during 1988 and 1989. My reading of the evidence certainly doesn't bear that out at all.

The Court: But then when we add to the January, '87 letter all the copies of checks, the subsequent notes in '87; there was a note in February of '87; there was a note in September; there was a note in December; there was the undated [77] million dollar note;

there were multiple copies of checks that have on the memo line "loan."

Mr. Sgherzi: Well, I understand what the court is saying, but to me that's not perfectly clear. Because, for example, on page 11 of the same document I referred to earlier, Macfarlane tells Cheng, "I need a tax shelter." The only purpose of a tax shelter that I'm aware of is to generate a loss. If you're going to generate a loss, I don't see how there would be any reasonable expectation of repaying it. It's just totally inconsistent.

This is testimony that came from the debtor's own mouth. It's nothing I said. His counsel was present. He had the opportunity to rehabilitate if there's a problem. This came from his deposition. How can you have a reasonable expectation of repayment on one hand and enter into a tax shelter, which the court is well aware of. The only purpose would be—

The Court: If you show me that any of that money went into the wind power systems, which is what that particular tax shelter was according to Mr. Macfarlane, which was not in '87 and not in '88 and not in '89, then we might talk about what's being excluded. But this was part of the problem and this is part of the threshold issue which, of course, the state doesn't like my March ruling on, and I understand that. I mean, I recognize that there is a split in authority, but I ruled in March and my position remains the same; and that is that the [78] claim filed by the state was prima facie valid. It was rebutted by the debtor. The state therefore has the burden of going forward, notwithstanding that it is a taxing authority, the state in non-bankruptcy circumstances would able to require the debtor, the taxpayer, to carry the burden of proof.

Mr. Sgherzi: Right. I understand completely what the court is saying, but I think you can see why the problem is the way it is. When you put that type of a burden on the state, it's almost impossible to enable it to do its job. It should make no difference whether it's in tax court or in bankruptcy court. I think the substantive law requires that the debtor prove his case, entitlement to a bad debt deduction, entitlement to anything else.

The Court: Well, I disagree with you in several particulars. One, I think there are probably—I mean, I don't know, but based upon the record I've seen, it seems to me that if there's evidence out there that in fact this was an embezzlement by Cheng, there was discovery that the state could have undertaken to establish the fact that it was embezzlement rather than a series of loans.

Secondly, that there were documents or amounts that don't add up and that show that at least some portions of the transactions are not accountable for as loans by any documentation, by any testimony and the like. None of that was done in the intervening months.

[79]

Mr. Sgherzi: I understand. I thought the record was clear. I spoke to my client. My client believed the record was clear that there was substantial doubt in terms of the alleged bad debt deductions during 1988 and 1989. But I understand if we're just talking about a particular event or two or three particular events that took place in 1988 and 1989, then I think we're dealing with something else. But when someone has an all-inclusive power of attorney and enables them to get money out whenever they want and to place it in this account and place it in that account,

that puts a real serious burden on trying to determine what exactly happened.

I believe that's why the law is the way it is outside of the bankruptcy context, which requires them to prove—

The Court: Well, that's right. Outside the bankruptcy context, that's how the burden would be. But there was nothing to prohibit your office from, for instance, going and taking Ms. Szuetenback's deposition and saying, all right now let's take this transaction and let's add up the sum totals, and what do you have that supports your contention that this was a loan or wasn't a loan and go through and establish what facts you contend are either, one, genuine issues of material fact that precludes this entry of judgment on this objection to claim, or two, establish that in fact it was an embezzlement, or that it wasn't a loan; it was something [80] else. Those opportunities were there.

Mr. Sgherzi: I understand that, but I just review the evidence somewhat differently. I think that there is still quite a bit of doubt in terms of what happened. I understand the court indicates it's my burden, but again I believe that—

The Court: Therein lies the crux of the problem.

Mr. Sgherzi: Exactly. I think really that's the major problem right there to be honest with you.

The Court: Thank you. Mr. Martin.

Mr. Martin: Well, your Honor has displayed a very extensive familiarity with the record, so I won't belabor the point except to say that I think there is undue emphasis placed on the concept of embezzlement here.

The Court: Well, I'm not finding embezzlement.

Mr. Martin: I understand that, your Honor, but I've explained and I thought I explained adequately that these takings were authorized pursuant to the power of attorney. There was a breach of fiduciary relationship, which is a civil problem. And I pointed out how under other cases—

The Court: Well, under traditional embezzlement law, the embezzler comes into possession of the property lawfully and then converts it.

Mr. Martin: Well, in any event, on the issue of evidence of transactions, I think your Honor is very familiar with it. Attached to the original objection at pages 248 [81] through 259 were copies of checks signed by Macfarland designated as loans to Cheng.

At pages 329 through 350 are copies of notes. The first one February, 1987, $250,000 signed by Cheng to Macfarlane. July 19, 1988, $600,000. There's another one page 331, one million dollars. There's another one which the record shows was prepared by Cheng's lawyer September 25th, 1987. It's a comprehensive note for $250,00. It was the context of this note that the documents referred to by the court were prepared evidencing an ongoing relationship, creditor/lender/borrower relationship, between Cheng and Macfarlane. And then there's the agreement which appears at page 333 dated July 31st, 1988, which again goes into a line of credit of up to $1,250,000.

I think there is no question that the record establishes that there was intended to be a debtor/creditor relationship, that the money was intended to be loaned to Mr. Cheng. I think the record also shows that it was misapplied by him, but that's not really relevant once the threshold issue of a debtor/creditor relationship has been shown.

The Court: I think that's right. And I went through the list of the assertedly uncontroverted facts set out in Exhibit 1 to the notice of this motion filed by the debtor and found that I could agree with each of those based upon the statements I've already made with respect to my tentative. And the same is true with respect to the conclusions of law, [82] including the burden issue. So every state has its remedy with respect to that.

Mr. Martin, will you prepare a proposed formal order and lodge it.

Mr. Martin: Thank you, your Honor.

Mr. Sgherzi: Thank you.

[83]

State of California)
County of San Diego)

I, Kathleen Cheyne, a shorthand reporter, do hereby certify that the foregoing hearing was taken before me at the time and place herein named; that said hearing was reported by me in shorthand and then transcribed through computer-aided transcription, and the foregoing transcript contains a true record of the said hearing.

I do further certify that I am a disinterested person and am in no way interested in the outcome of this action.

In witness whereof, I have hereunto set my hand on the 21st day of July, 1993, at San Diego, California.

/s/ KATHLEEN CHEYNE
KATHLEEN CHEYNE

Supreme Court, U.S.
FILED
JAN 9 1997
CLERK

(6)

No. 96-235

In The

Supreme Court of the United States

October Term, 1996

FRANCHISE TAX BOARD OF THE STATE OF CALIFORNIA,

Petitioner,

v.

STEPHEN B. MACFARLANE,

Respondent.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

REPLY TO AMICUS BRIEF OF THE UNITED STATES

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REPLY BRIEF OF PETITIONER IN RESPONSE TO THE BRIEF OF THE UNITED STATES AS AMICUS CURIAE

Amicus curiae, United States, fully agrees with petitioner and the 24 amici states that the burden of proof issue presented in the petition is an important and recurring issue on which there is a direct conflict in the circuits. The United States also fully agrees with petitioner and the amici states that the Ninth Circuit erred in holding against petitioner on this issue. However, the Solicitor General contends that this case is not an appropriate vehicle for resolving this issue. This contention is based upon the misconception that there was no "final order" before the Ninth Circuit when that court accepted the case.

At pages 12-13 of his brief the Solicitor General contends that "[a] district court order that denies a motion for summary judgment on the ground that material issues of fact remain in controversy is not a 'final' order from which an appeal may be taken. . . . " The petitioner is in agreement with this statement. What the Solicitor General fails to recognize, and what is clearly expressed in the district court's appellate decision, is that there were *two separate rulings* being reviewed by the district court: the ruling granting, based on findings of fact and conclusions of law, the motion for denial of the claims, and the ruling granting the motion for summary judgment. (Pet.App. 12.) The district court's affirmance of the bankruptcy court's ruling on the debtor's motion for denial of the claim disposed of the case on the merits. (Pet.App. 12.)

The district court's judgment specifically provides that, " . . . the Bankruptcy Court's findings of fact and

conclusions of law on the motion for denial of claim, Bankruptcy Docket #181, are affirmed *and* the Bankruptcy Court's grant of summary judgment denying the Board's claim, Bankruptcy Docket #235 is reversed. . . . " (Pet.App. 12, emphasis added.) This shows that the district court made separate rulings with respect to *both* matters: the denial of the claim, based upon the findings of fact and conclusions of law, and the motion for summary judgment on the claim.[1] The district court's affirmance of the findings of fact and conclusions of law constituted a "final order" which provided the Ninth Circuit with proper appellate jurisdiction.

Under the circumstances, this case is therefore properly treated on appeal the same as one that is submitted for a bench trial on a stipulated record. (*See, Ojai Unified School Dist. v. Jackson*, 4 F.3d 1467, 1472 (9th Cir. 1993); *Vetter v. Frosch*, 599 F.2d 630, 632 (5th Cir. 1979).)

The petitioner agrees that the district court's opinion contains an internal inconsistency: having affirmed the bankruptcy court's denial of petitioner's claim, on the basis of findings of fact and conclusions of law, the district court should have noted that the summary judgment motion was moot. *See, Huval v. Offshore Pipelines, Inc.*, 86 F.3d 454, 458 (5th Cir. 1996).

The record does not support the United States' assertion that "[t]he posture of the case at the conclusion of

---

[1] The memorandum decision of the district court specifically held that, ". . . . this court must consider this matter as both an appeal from a summary judgment and an appeal from the bankruptcy court's decision on the merits of the Board's Proof of Claim." (Pet.App. 18.)

these proceedings in the district court was thus simply that a motion for summary judgment had been denied." (U.S. Br. p. 12.) The district court distinctly affirmed the bankruptcy court's final ruling on the merits (based upon findings of fact and conclusions of law) on the debtor's motion for denial of claim. In reaching separate findings of fact and conclusions of law regarding the denial of claim motion, the bankruptcy court was acting outside the context of the summary judgment motion. The district court judgment separately addressed the merits of the bankruptcy court's action on the denial of claim motion; therefore that judgment constituted a final order subject to appellate review.

While there is language in the Ninth Circuit's opinion suggesting that " . . . further proceedings in bankruptcy court are contemplated" (Pet.App. 6), there is nothing in the record to indicate that the district court contemplated any such proceeding.[2] In fact the Ninth Circuit opinion goes on to provide that, "[t]he judgment of the district court is REVERSED and the case REMANDED to the bankruptcy court for entry of judgment in favor of Macfarlane." (Pet.App. 11.)

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[2] The district court's judgment contains absolutely no provision for further factual determination proceedings. Findings of fact and conclusions of law were already made and entered by the bankruptcy court. (Pet.App. 37-42.) The Board's claim was clearly denied. The fact that, without petitioner's appeal to the Ninth Circuit, the bankruptcy court might have entered judgment to carry out the district court's appellate decision does not change the district court's order into a non-final order.

This Court clearly is presented with an appropriate vehicle with which to resolve the "burden of proof" issue. Had the petitioner failed to file its appeal when it did in the Ninth Circuit, petitioner would have lost the opportunity for appellate review of the adverse holding on the motion denying its claim – a final order disposing of the case on the merits. Since, under the district court's holding, there were no additional findings of fact or conclusions of law which needed to be made, remand to the bankruptcy court for further factual determination proceedings would have served no purpose.

This Court is presented with a single legal issue: should the burden of proving entitlement to a bad debt deduction be shifted to the government when a tax claim is litigated in the bankruptcy court? The Ninth Circuit had jurisdiction to consider petitioner's appeal of the district court's final order on the merits of this issue. The Ninth Circuit's erroneous holding on this important and recurring issue presented by the petition is properly before this Court for review.

For the reasons given above and in the petition for writ of certiorari it is respectfully submitted that the petition should be granted to resolve an issue which the United States recognizes is (1) important, (2) recurring,

(3) in conflict within the circuits, and (4) erroneously decided in the Ninth Circuit's decision.

Respectfully submitted,

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Supreme Court, U.S.
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In The

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October Term, 1996

FRANCHISE TAX BOARD OF THE STATE OF CALIFORNIA,

Petitioner,

v.

STEPHEN B. MACFARLANE,

Respondent.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

RESPONDENT'S SUPPLEMENTAL BRIEF NOTING ERROR IN REPLY BRIEF OF PETITIONER TO AMICUS BRIEF OF THE UNITED STATES

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JUSTIFICATION FOR RESPONDENT'S SUPPLEMENTAL BRIEF

On December 30, 1996, the United States filed its amicus brief. On January 9, 1997 Petitioner filed its reply. Petitioner's reply was not served on Respondent at the address in his Brief in Opposition. Accordingly it reached Respondent only after an attorney from Washington, D.C., called the undersigned with a question related to Petitioner's reply and a search was initiated which resulted in location of the brief in the Diamond Bar, California Post Office on January 31, 1997.

On January 15, 1997, the Court ordered the transmission of the record from the Ninth Circuit and the lower court apparently to address the confusion created by these two briefs. On January 21, 1997 the undersigned wrote to the clerks of this Court and of the Ninth Circuit in response to this order commenting that there are two courts lower than the Ninth Circuit in this case and the Court's order may be interpreted as requiring the transmission of the records in both of these courts.

Neither of these briefs accurately review the pertinent circumstances, and the two together raise the issue of whether Petitioner has consistently elected a line of argument which bars the invocation of the jurisdiction of this Court.

THE UNITED STATES MISUNDERSTOOD THE RECORD AND THE POSTURE OF THE CASE

The brief of the United States incorrectly assumes that only a motion for summary judgment was made by

Respondent, ignores the order by the Bankruptcy Court which was clearly final, and doesn't observe the absence of any remand in the District Court's order. It also incorrectly states that materiality of facts was not in issue. United States Brief at 13 n. 5.

The Ninth Circuit in reviewing the order of a District Court or Bankruptcy Appellate Panel sitting as an intermediary appeals court reviews the judgment of the bankruptcy court because it is in as good a position for review as was the appeals court. Respondent in his Ninth Circuit brief pointed that out. Respondent's Brief in Opposition App. 3 citing *In re Marquam Inv. Corp*, 942 F.2d 1462, 1465 (9th Cir. 1991). *See similarly, Cypher Chiropractic Center v. Runski (In re Runski)*, 102 F.3d 744, 745 (4th Cir. 1996). Respondent raised the finality issue in the only portion of his Ninth Circuit brief not printed as an appendix to his Brief in Opposition here, attached to this brief as Appendix D, but contended that it should be resolved in favor of finality for the reasons stated in the Respondent's "Standard of Review" discussion which was printed in Respondent's brief in this Court. Respondent's Brief in Opposition App. 3-6. The United States' brief overlooks the implications of the posture of the District Court as a court of appeal under bankruptcy jurisdiction. The United States' statement that an appeal from a denial of a summary judgment by a District Court is not final is correct, but not applicable and not supported, technically, by the decisions cited except for a strained application of *Bacchus v. Taylor (In re Bacchus)*, 718 F.2d 736 (5th Cir. 1983) which was not even a Bankruptcy Code case. *See contra Turgeon v. Victoria Station, Inc., (In re Victoria Station, Inc.)*, 840 F.2d 682 (9th Cir. 1988) (citing *Caravansary,*

Inc. v. Passanisi (In re Caravansary, Inc.), 821 F.2d 1413, 1414 (9th Cir. 1987) cited by the United States) and *Breyfogle v. Grange Mut. Cas. Co. (In re Gardner)*, 810 F.2d 87 (6th Cir. 1987) (citing *In re TCL Investors*, 775 F.2d 1516 (11th Cir. 1985) cited by the United States).

Contrary to the United States' Brief at 13 n.5, Respondent also clearly raised materiality of the facts relied on by the District Court in finding a factual controversy. Respondent's Brief in Opposition App. 2 (Statement of Issues 2), App. 9 (Argument Summary), App. 12-13 (controverted material fact discussion).

The United States' brief ignores the steadfast assertion by Respondent, and even the opinion in the District Court, that there were two motions before the Bankruptcy Court. Respondent in his motion for reconsideration made that abundantly clear, Appendix A. Respondent's Ninth Circuit brief has the same notation. Respondent's Brief in Opposition App. 4 and 8. Likewise, the District Court opinion. Petitioner's App. 18.

Contrary to the United States' brief, this Court, as well as the Ninth Circuit, adopts the "pragmatic" approach to appeals criticized in footnote 5 of the United States' brief:

> Both the Supreme Court and the Ninth Circuit have stated that they take a "pragmatic approach" to the final judgment rule and may find a judgment final for purposes of that

statute even though the judgment is not technically final.[1]

Respondent therefore suggests that the position of the United States regarding jurisdiction is uninformed, but perhaps correct for the following reason.

THE PETITIONER HAS CONSISTENTLY ELECTED TO ARGUE ONLY ON SUMMARY JUDGMENT GROUNDS WIHCH ARE INAPPROPRIATE FOR CERTIORARI

The latest brief of the Petitioner indicates an issue of propriety of the Petition may be present. The Petition misled the United States regarding the procedural posture of this case, but this Court should not be misled by it. Petitioner's latest brief is completely contrary to every brief it has filed in this case from inception. Here, for instance, it relies on *Ojai Unified School Dist. v. Jackson*, 4 F.3d 1467, 1472 (9th Cir. 1993). Petitioner's Reply to Amicus Brief of United States at 2. In the Ninth Circuit Petitioner referred to this jurisdictional issue as a "one winged flight of fantasy", Appendix E, and dismissed *Ojai* as "totally irrelevant." Appendix E. Petitioner, as indicated in its briefs below, App. 10, 11 and 23, and in its Petition here, at 4, states that it is here appealing only insofar as the summary judgment is involved. Therefore according to the United States it is not properly here.

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[1] Ulrich, Thompson, and Kessler, P.C. and Sidley and Austin, *Federal Appellate Practice Guide: Ninth Circuit* §3.6 at 3-23 (1994) collecting authorities in n.72.

More importantly, perhaps, the Ninth Circuit affirmed on multiple grounds, as urged by Respondent. As noted in Respondent's Brief in Opposition, affirmance may be on any basis appearing in the record and certiorari is not granted merely to review evidence. Petitioner offered no evidence below with which to raise a burden of proof issue and has steadfastly relied solely on a summary judgment argument in which the only issue is whether there are any controverted material facts. That is the only issue which Petitioner can with any procedural integrity raise here and that is not appropriate for certiorari. Petitioner undoubtedly elected this position to avail itself of the de novo standard for review. Having elected that position, it must live or die with it.

If the question on appeal occurs as frequently and is as important as asserted by Petitioner, by most of the rest of the States, and by the United States, then there should be along shortly another appeal in which the question is properly presented.

Respectfully submitted,

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APPENDIX A

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UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF CALIFORNIA

IN RE: STEPHEN B. MACFARLANE, Debtor.	) District Court) No. 93-1435G/R)) APPELLEE'S MOTION FOR REHEARING AND MEMORANDUM IN SUPPORT (F.R.B.P. 8015)
CALIFORNIA FRANCHISE TAX BOARD, Appellant, v. STEPHEN B. MACFARLANE, Appellee.	) [Hearing Date Reserved:]) DATE: November 28, 1994) TIME: 10:30 o'clock a.m.) PLACE: Courtroom 5 940 Front Street San Diego, California

TO THE CALIFORNIA FRANCHISE TAX BOARD:

YOU ARE HEREBY NOTIFIED that the Debtor/Appellee hereby moves the Court for rehearing and to

amend its judgment in this matter filed June 29, 1994. This controversy is an appeal from a bankruptcy court judgment.

This Motion is made pursuant to Federal Rule of Bankruptcy Procedure 8015 which is intended to be applied consistently with Federal Rule of Appellate Procedure 40. Under Federal Rule of Appellate Procedure 40 "[n]o answer to a petition for rehearing will be received unless requested by the Court. . . . If a petition for rehearing is granted the Court may make a final disposition of the cause without reargument. . . . "

In the event a hearing is held, it will be held at 10:30 o'clock a.m. on November 28, 1994 before the Honorable John S. Rhoades at Courtroom 5, 940 Front Street, San Diego, California.

If the Court requests a response to this Motion, it must be filed in accordance with the Court's request or in any event not later than 14 calendar days prior to November 28, 1994, plus an additional three days if you serve your response by mail.

This Motion is based on the Court's decision in this case filed June 29, 1994, the record on appeal and the accompanying memorandum.

Dated: July 6, 1994

Elmer Dean Martin III
Attorney for Appellee
Stephen B. Macfarlane

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UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF CALIFORNIA

IN RE: STEPHEN B. MACFARLANE, Debtor.	) District Court) No. 93-1435G/R) MEMORANDUM OF POINTS AND AUTHORITIES IN SUPPORT OF APPELLEE'S MOTION FOR REHEARING
CALIFORNIA FRANCHISE TAX BOARD, Appellant, v. STEPHEN B. MACFARLANE, Appellee.	) [Hearing Date Reserved:]) DATE: November 28, 1994) TIME: 10:30 o'clock a.m.) PLACE: Courtroom 5 940 Front Street San Diego, California

INTRODUCTION

As noted in the Motion, this pleading is governed by Federal Rule of Bankruptcy Procedure 8015. It is a bankruptcy appeal. Federal Rule of Appellate Procedure 40 is made applicable by F.R.B.P. 8015. This procedural context

is discussed in Sections 12.43 and 9.11 of Federal Appellate Practice Guidelines – Ninth Circuit (1994), copies of which are attached at pages 9 to 15 of the Appendices.

QUESTION PRESENTED ON REHEARING

Should the judgment of the Bankruptcy Court be affirmed because it was not a summary judgment and the findings and conclusions on which it was based have been affirmed by this Court.

COURSE OF PROCEEDINGS

Debtor filed an objection to a claim of the California Franchise Tax Board. As stated at pages 8 and 9 of Debtor's brief on appeal:

> On March 15, 1993 the bankruptcy court conducted a hearing on the Debtor's objection of the FTB claim. Volume 1 R.A. 167-173. The court ruled that the FTB's claim was prima facie valid but that the Debtor had provided competent evidence that debts existed in 1988 and 1989 and that the debts were worthless in 1988 and 1989 rebutting the presumption of validity of the FTB claim. The court then adjourned the hearing to July 12, 1993 to allow the FTB to conduct discovery and offer evidence.
>
> The FTB chose to forego discovery and offered no evidence. On June 11, 1993 the Debtor filed a motion for summary determination of the claim noting the lack of any activity by the FTB, Volume 1 R.A. 114 and 121, *and in the alternative requested that the objection to the claims of the FTB be determined on the merits on the*

> *evidence submitted applying traditional procedures for ruling on objections to claims. Volume 1 R.A. 122 lines 1-3.* The FTB did not respond with a statement of controverted facts or conclusions of law. It responded with a memorandum which dealt primarily with burden of proof issues and apparently contended that not only must the Debtor prove that the amounts involved were loans which became worthless in the years claimed but also that they were not theft losses. . . .
>
> At the hearing on July 12, 1993 the bankruptcy court comprehensively addressed the issues on the merits of the evidence on the basis of the objection without addressing the summary judgment motion. Volume 1 R.A. 70-83. (Emphasis added).

This Court noted the presence of both the objection and the motion. Decision page 6, lines 10-20. However, this Court did not in its decision note that the motion for summary judgment was expressly in the alternative to a motion for decision on the merits as a controverted matter. On June 29, 1994 this Court affirmed the findings and conclusions but reversed the judgment.

ARGUMENT

The Bankruptcy Court made findings and conclusions and recited in them that they were pertinent to Debtor's motion "for a denial of the claims of the California Franchise Tax Board . . . in the contested matter commenced by Debtor's objection to such claims. . . . " The Conclusions and the Findings, and the Court's colloquy, indicate that the Court was weighing the evidence in

the context of the objection and not in the content of a summary judgment motion. Vol. 1 R.A. 50-54; Appellee's Brief pages 9 to 10. The judgment likewise does not refer to summary proceedings. Vol. 1 R.A. 50-54.

Neither the Court, Appellee nor the Appellant dealt with this matter at the final hearing as if it was going to be disposed of as a summary judgment.

In addition, the Ninth Circuit has repeatedly held that even though a lower court may have relied on wrong grounds or reasoning, a decision that is correct on any ground fairly supported by the record will be affirmed, even if a ground is not asserted by the appellee or has been expressly disavowed by the appellee. *Nugget Hydroelectric, L.P. v. Pacific Gas & Elec. Co.*, 981 F.2d 429, 435-36 (9th Cir. 1992); *Unigard Sec. Ins. Co. v. Lakewood Eng'g & Mfg. Corp.*, 982 F.2d 363 (9th Cir. 1992); *Jackson v. Southern California Gas Co.*, 881 F.2d 638, 643 (9th Cir. 1989); *Lee v. United States*, 809 F.2d 1406, 1408 (9th Cir. 1987); *Beezley v. Fremont Indem. Co.*, 802 F.2d 466 (9th Cir. 1986) (per curiam); *Bruce v. United States*, 759 F.2d 755, 758 (9th Cir. 1985); *Industrial Indem. Ins. Co. v. United States*, 757 F.2d 982, 987 (9th Cir. 1985) (can affirm if argument is fairly presented in the record); *Marino v. Vasquez*, 812 F.2d 499, 508 (9th Cir. 1987); *Keniston v. Roberts*, 717 F.2d 1295, 1300 & n.3 (9th Cir. 1983); *Thomas P. Gonzalez Corp. v. Consejo Nacional de Produccion de Costa Rica*, 614 F.2d 1247, 1256 (9th Cir. 1980); *Boehm v. American Broadcasting Co.*, 929 F.2d 482, 487 (9th Cir. 1991); *In re Wind Power Sys., Inc.*, 841 F.2d 288, 290 n.1 (9th Cir. 1988) (Ninth Circuit would consider issues first raised on appeal to affirm a summary judgment because the parties were not disputing the bankruptcy court's complete findings of fact and the

issues raised were purely questions of law); *Angle v. United States*, 709 F.2d 570, 573 (9th Cir. 1983) ("we have often asserted that we can affirm a ruling on any ground supported by the record, even if that ground is not asserted by the appellee"); *See, e.g., Aguon v. Calvo*, 829 F.2d 845 (9th Cir. 1987) (appellee unsuccessfully urged the court not to address an issue first raised by the court).

CONCLUSION

This appeal was filed by the California Franchise Tax Board on August 19, 1993. First assigned to Judge Gilliam, it was reassigned to Judge Huff who recused herself after considering the case, and it was then reassigned to the present judge.

Little purpose would be served by remand to the bankruptcy judge for entry of judgment again on the findings and conclusions which have been affirmed by this Court. Appellee suggests that the Court should affirm the judgment as properly founded upon the findings and conclusions, or, if the Court deem it necessary, explicitly remand for entry of judgment on the findings and conclusions. The remand will require the Appellant

to return to this Court on its way to the Ninth Circuit. Appellee wishes to avoid this circuitous route.

Respectfully submitted,

Dated: July 6, 1994

Elmer Dean Martin III
Attorney for Appellee
Stephen B. Macfarlane

APPENDIX B

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UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF CALIFORNIA

In re: STEPHEN B. MACFARLANE, Debtor.	District Ct. No. 93-1435G/R APPELLANT'S RESPONSE TO APPELLEE'S MOTION FOR REHEARING [F.R.B.P. 8015]
FRANCHISE TAX BOARD, Appellant, -vs- STEPHEN B. MACFARLANE, Appellee.	DATE: November 28, 1994 TIME: 10:30 A.M. PLACE: Courtroom "5" 940 Front St. San Diego, CA.

TO THE HONORABLE JOHN S. RHOADES, UNITED STATES DISTRICT COURT, SOUTHERN

DISTRICT OF CALIFORNIA, APPELLEE, STEPHEN B. MACFARLANE, COUNSEL OF RECORD, and other parties in interest, Appellant Franchise Tax Board, State of California files this response to Appellee's Motion for Rehearing pursuant to Federal Bankruptcy Rule 8015.

INTRODUCTION

This Court exercised its appellate jurisdiction over a final order of the bankruptcy court which adjudicated a claim of Appellant, Franchise Tax Board in the Macfarlane bankruptcy estate. *(28 U.S.C. § 158(a).)* On appeal this court affirmed the bankruptcy court's denial of the Board's claim and reversed the bankruptcy court's grant of summary judgment denying the Board's claim. The appellee filed a timely motion for reconsideration from this court's order. *(F.R.B.P. 8015).*

In their motion for reconsideration the appellee asks this Court to reconsider its ruling with respect to its reversal of the appellee's summary judgment motion.

Appellant Board contends that it is not necessary for this Court to expend its time in reconsidering its decision on the appeal from the bankruptcy court order in this case. The Board contends that there is no implied inconsistency with respect to this Court's appellate order regarding the Macfarlane matter.

ARGUMENT

The fact that Macfarlane filed a motion for summary determination of a claim regarding the Franchise Tax Board is beyond dispute. By filing a motion for summary

determination with the bankruptcy court Macfarlane obviously expected the court to act on the motion.

The debtor's concern over the fact that this Court, exercising its appellate jurisdiction, affirmed the denial of the Board's claim while reversing its motion for summary determination is not problematic. This perceived inconsistency results from the different standards of proof governing claims adjudication versus motions for summary judgment as well as the differing standards that this Court must employ when exercising appellate jurisdiction over these matters. As set forth in this Court's opinion, "[T]he bankruptcy court's findings of facts on the merits are reviewed under the clearly erroneous standard, while the motion for summary judgment is reviewed de novo."

As a matter of law in ruling on a motion for summary judgment the record evidence is reviewed in the light most favorable to the party opposing the summary judgment motion. (*Nillson, Robbins, Dalgakn, et al. v. Louisiana Hydrolic,* 854 F.2d 1538, 1542 (9th Cir. 1988).) The court cannot and will not consider and weigh conflicts in the evidence in ruling on a summary judgment motion. (*Anderson v. Liberty Lobby Inc.*, 477 U.S. 242, 249 (1986).)

This Court, in its opinion pointed out the various inconsistencies in the evidence which precluded it from finding that a motion for summary judgment in favor of Macfarlane should have been granted. This Court found, that as a matter of law, the Board had met its burden in opposing a motion for summary judgment by designating

specific facts in the record evidence showing that a genuine issue for trial existed. (*Celotex Corp.* v. *Catrett*, 477 U.S. 317, 325 (1986).)

The issue of whether or not the cash advances from Macfarlane to Cheng were loans involves the intent and state of mind of the parties. Cases involving motives, intent, or state of mind are inappropriate for resolution by a motion for summary judgment. (*Vucinich v. Paine Weber, et al.*, 739 F.2d 1434, 1436 (9th Cir. 1984); *Blair Foods, Inc. v. Ranchers Cotton Oil*, 610 F.2d 665, 668 n.3 (9th Cir. 1980).)

The debtor's rehearing motion contending that, "a decision that is correct on any ground fairly supported by the record will be affirmed", followed by an extensive string citation support the Board's position that a rehearing in this case is absolutely unnecessary and would serve no purpose. This matter is best left to proceed to the Ninth Circuit for resolution so that the Ninth Circuit can rule on the burden of proof issue in bankruptcy courts in which there is a conflict between the United States Court of Appeals for the Fourth and Fifth Circuits.

CONCLUSION

For the reasons stated this Court should refrain from granting the Appellee's motion for rehearing.

Dated: November 10, 1994

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UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF CALIFORNIA

IN RE: STEPHEN B. MACFARLANE, Debtor.	) District Court) No. 93-1435G/R)) APPELLEE'S REBUTTAL TO APPELLANT'S RESPONSE TO APPELLEE'S MOTION FOR REHEARING
CALIFORNIA FRANCHISE TAX BOARD, Appellant, v. STEPHEN B. MACFARLANE, Appellee.	DATE: November 28, 1994 TIME: 10:30 a.m. PLACE: Courtroom 5 940 Front Street San Diego, Cal.

Appellee responds to "Appellant's Response to Appellee's Motion for Rehearing" solely to note that Appellee does not want to deprive Appellant of its test

case in the Ninth Circuit. Appellee simply does not want to go there twice in the course of that test.

As extensively amplified in Appellee's motion, Appellee filed his objection to the Appellant's claim, the bankruptcy court ordered that the Appellant should have an opportunity for discovery, Appellant conducted no discovery, and Appellee moved in the alternative for summary judgment or for a determination on the evidence presented with the objection as is done in claims objection proceedings. The Court weighed the evidence, determined that the Appellant had not carried its burden and entered judgment.

Ironically, the Appellant is taking a position inconsistent with its desire to present the Ninth Circuit with the burden of proof issue. The Ninth Circuit could easily dispose of this matter without addressing the burden of proof issue if the judgment appealed from is a summary judgment. Appellee simply wants to avoid having to travel this route twice.

For the reasons stated in the Motion, the judgment based on the findings and conclusions which have been affirmed should also be affirmed both because the record supports that disposition and because it is consistent with the desire of both litigants to present the burden of proof issue to the Ninth Circuit in a context in which it must be decided.

Dated: November 14, 1994

Elmer Dean Martin III
Attorney for Appellee
Stephen B. Macfarlane

APPENDIX D

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

In re STEPHEN B. MACFARLANE Debtor.	)	CASE NOS. 94-56064 94-56065 [DC # CV-93-01435-JSR So. Dist. San Diego]
FRANCHISE TAX BOARD OF THE STATE OF CALIFORNIA, Appellant/Cross Appellee/Creditor, -vs- STEPHEN B. MACFARLANE, Appellee/Cross Appellant/Debtor	)	

COMBINED CROSS APPEAL OPENING AND APPEAL REPLY BRIEFS OF STEPHEN B. MACFARLANE

APPEAL FROM A JUDGMENT OF THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF CALIFORNIA

Honorable John S. Rhoades
United States District Judge

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Appellee Stephen B. Macfarlane

STATEMENT OF SUBJECT MATTER AND APPELLATE JURISDICTION

This is an appeal from district court review of a judgment of a bankruptcy court sustaining an objection to a claim for taxes asserted by the California Franchise Tax Board ("FTB"). The bankruptcy court had core matter jurisdiction under 11 U.S.C. § 505 and 28 U.S.C. § 157(b)(2)(B). This Court appears to have jurisdiction of the appeal and cross-appeal in this case from the order of the district court under 28 U.S.C. § 158(d). The district court had jurisdiction under 28 U.S.C. § 158(a) to hear an appeal from the final judgment of the bankruptcy court as noted by the FTB in its opening brief. The district court entered its judgment on June 29, 1994. Supp. ER9. On July 27, 1994 Debtor filed his notice of appeal from the portion of the judgment which related to reversal by the district court of summary judgment by the bankruptcy court timely as provided by FRAP 4(a)(1). Supp. ER3.

Debtor notes that the district court characterized its decision as a reversal of a summary judgment by the bankruptcy court but affirmed the bankruptcy court's findings and conclusions as not clearly erroneous. Supp.

ER9. This decision may be interpreted as requiring further proceedings in the bankruptcy court and therefore may not be a final order. *In re Bonner Mall Partnership*, 2 F.3d 899, 903 (9th Cir. 1993); *In re Vylene Ent., Inc.*, 96 F.2d 887, 891 (9th Cir. 1992). Debtor believes that this Court has jurisdiction for the reasons stated herein regarding the applicable standard of review.

Cross-Appellant Stephen B. Macfarlane ("Debtor") notes at the outset that this Court may determine that the FTB has failed to perfect its appeal because it may not have filed its opening brief and excerpts of record in conformity with this Court's rules. The FTB's brief and excerpts appear to be questionable as follows: (1) The docket of the district court is not included and references in the brief are not to the district court record. Certificate of Record second paragraph in Supp. ER2. Debtor adopts for its brief the convention of referring to the FTB's excerpts as ER (tab number) but with reference to the district court's docket number as DCR ___. The supplemental excerpts of the Debtor are referred to as Supp. ER (tab number) and are paginated separately for each tab number. The district court record was a stipulated record. Supp. ER1. Debtor's Supp. ER4, 5, 6 and 7 follow the four volume district court record retaining the district court record stamped numbers on the right bottom of each page. There is some minor duplication of pages in the FTB's excerpts for the sake of ease of reference inasmuch as the FTB did not refer to the district court record. Circuit Rule 30-1.4; (2) Certain of the FTB's excerpts are not paginated, including the district court's decision. Debtor has included paginated duplicate copies of these items in his excerpts for ease of reference. Circuit Rule

30-1.4; (3) Unnecessary inclusion of legal memoranda. Circuit Rule 30-1.3; 30-2; (4) Inaccurate references to ER. For instance, at page 29 of the FTB brief, the reference is to factual statements but the citation is to ER10 which is the Debtor's BAP objection. Circuit Rule 30-1.3; 30-2; (5) Failure to reference page numbers in large documents. ER6 is two depositions with 165 pages yet there are numerous references to it without page specification. Circuit Rule 30-1.3; 30-2; (6) No reference to bankruptcy judge. Court Rule 28-2.9; (7) Inappropriate and unsupported factual statements. See *infra*; (8) Improper size typeface in footnotes. FRAP 32; (9) No addendum of authorities. Circuit Rule 28-2.7; (10) No specification of where in the record an issue was raised or resolved in connection with the specification of standard of review. Circuit Rule 28-2.5; (11) No related case statement. Circuit Rule 28-2.6; (12) Length exceeds 35 pages. Circuit Rule 28-3.2; (13) Entire text not double spaced. FRAP 32(a); (14) No summary of argument. FRAP 28(a)(5).

APPENDIX E

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

In re STEPHEN MACFARLANE) Debtor.)	CASE NOS. 94-56064 94-56065
FRANCHISE TAX BOARD OF THE STATE OF CALIFORNIA, Appellant/Cross-Appellee/Creditor, -vs- STEPHEN MACFARLANE, Appellee, Cross-Appellant/Debtor)	[DC # CV-93-01435-JSR So. Dist. of California]

ANSWERING BRIEF OF CROSS-APPELLEE AND APPELLANT FRANCHISE TAX BOARD OF THE STATE OF CALIFORNIA

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THE APPELLANT HAS APPEALED FROM A FINAL ORDER

The debtor-appellee devotes needless time questioning this Court's jurisdiction to review the district court decision at issue here, and implies that this decision may not be final merely because the case might ultimately be remanded back to the bankruptcy court where the controversy commenced. (DOB[1] at p. 5).

This Court has specifically held that the approach to finality of bankruptcy court orders "focuses on whether the decision appealed from 'effectively determined the outcome of the case', or determined a controversy. *(Elliot v. Four Seasons Properties (In re Frontier Properties, Inc.),* 979 F.2d 1358, 1363 (9th Cir. 1992); *Mason v. Integrity Ins. Co. (In re Mason),* 709 F.2d 1313, 1316 (9th Cir. 1983).) To determine whether a district court order is final the Ninth Circuit will look to the nature of the order. (*Security Pacific Bank Washington v. Steinberg,* 971 F.2d 387, 389 (9th Cir. 1992)).

In a one-winged flight of fantasy, the debtor-appellee cites absolutely no authority for the proposition that the finality of an order is diminished merely because an appellate court may remand the case back to a lower court for entry of an order consistent with its appellate opinion.

"The unique nature of bankruptcy proceedings dictate that we take a pragmatic approach to finality." (*Vylene Enter., Inc. v. Naugles,* 968 F.2d 887, 894 (9th Cir.

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[1] The designation "DOB" refers to Debtor-Appellee's Opening Brief.

1992); *In re Market Square Inn, Inc.*, 978 F.2d 116, 120 (3rd Cir. 1992)). The debtor-appellee cites no authority to the contrary.

III.

THROUGHOUT HIS BRIEF THE DEBTOR-APPELLEE CITES LEGAL AUTHORITY HAVING ABSOLUTELY NO RELEVANCE EITHER DIRECTLY OR INFERENTIALLY TO THE FACTS OF THIS CASE

The debtor-appellee cites the *Ojai Unified School District* case as an example of the appropriate standard of review this Court should employ with respect to the issues contained in its cross-appeal. (DOB p. 8). Since the *Ojai* case dealt with appellate review of an agency decision pursuant to 20 U.S.C. § 1412, et seq. (Individuals with Disabilities Education Act), it is totally irrelevant to the standard of review to be employed in this case.

The court in *Ojai* pointed out that "although (the procedure used here) is permissible under IDEA, *it is not a true summary judgment procedure.*" (*Ojai* at p. 1472). The debtor's brief fails to note this distinction. (DOB at p. 8).

Next, the debtor-appellee cites *Kreisner* for the incorrect legal proposition that the clearly erroneous standard of review should apply with respect to the summary judgment issue in this case. (DOB p. 8). What the debtor-appellee fails to reveal to this court is what the dissent in *Kreisner* expressly noted: that,

> " . . . garden variety summary judgment cases, like *Swarner*, are far different from this one." (*Kreisner* at p. 887 f.n.3).

The law in this circuit is clear. A grant or denial of a motion for summary judgment, including a determination as to whether genuine issues of material facts exist, is reviewed de novo.[2] (*U.S. v. Williams*, 994 F.2d 646, 648 (9th Cir. 1993); *Curnow v. Ridgecrest Police*, 952 F.2d 321, 323 (9th Cir. 1991)).

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[2] In addition, factual findings made under a mistaken view of the applicable law or using the incorrect legal standard are characterized as legal error. (*Inwood Labs, Inc. v. Ives Labs, Inc.*, 456 U.S. 844, 855 f.n. 15).